

MWE CONSULTING PTY LTD

ABN: 81 092 713 598

66a St Helens Road
East Hawthorn
Victoria
Australia 3123
Phone: 03 9882 5766
Mobile: 0412 519 534
Email: mebstein@bigpond.com

July 8, 2011

Dr Christopher Kent
Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

Dear Dr Kent

Introduction

The decision by the Reserve Bank to review the Standard on Merchant Pricing is a positive move to address the shortcomings of the Standard. The initial decision of the Reserve Bank to remove the scheme prohibition on credit card surcharging was introduced to provide merchants with the capacity to recover the costs of what had become an important component of the Australian payments landscape.

I was involved in the credit card industry at ANZ prior to the Reserve Bank's payment reforms and have since been active as an independent consultant and adviser in the payments space.

Background

Although merchants had the ability to differentiate pricing prior to the introduction of the Standard in 2003 by discounting alternative payment products, this was not a common practice. The great majority of merchants recognised that competition for consumer custom was intense. This generally led to a minimum of barriers to execution of the transaction, and prices were determined by factoring in all associated costs. These would usually include labour, rent, marketing, the cost of goods, utility payments and, presumably, the cost of accepting payment.

I have no issue with the decision of the RBA to remove the previous embargo on surcharging of credit cards. As a principle, I much prefer incentives rather than prohibitions to stimulate use. But an underlying issue remains. As demonstrated and indeed quantified in the Reserve Bank's November 2007 paper, "Payment Costs In Australia", merchants face costs for all generally accepted payment types. This includes scheme cards, eftpos, cheques and cash. In announcing the Standard on Merchant Pricing in 2002, the Reserve Bank stated, "The higher costs of credit cards will no longer need to be built into the prices of goods and services paid by all consumers, whether or not they pay by credit card."

This means that merchants have a choice: 1) Calculate the cost of sales of a product with a blend of all payment types to determine a standard retail price; or 2) calculate the cost of sales with a blend of payment types excluding credit, and then apply a surcharge for credit. My concern with option 2) is the extent to which merchants actually factor in the costs of alternative payment products or indeed even recognise that they incur costs in accepting these. Given that merchants have analysed their costs and factored in a blended cost for payments by other than credit card, then it follows that a surcharge for credit should only recover the difference between the two. To pass on the entire cost of a credit card transaction presumably means that a merchant is prepared to accept alternative payments with nil recovery. There is an inconsistency in this logic.

As indicated earlier, pricing differentiation was rarely encountered prior to 2003 although available as a tool by merchants. To some extent, I feel that the directive by the Reserve Bank to remove the prohibition on surcharging has at least partially provided the merchant community with an imprimatur to pass on the cost of credit card acceptance whilst not applying a similar impost for other payment types.

Issues

In the order that the Consultation Paper presented the issues, my comments follow:

- i) I endorse the move by the Payments System Board to review the Standard that permits surcharging. This review should establish to what extent sections of the merchant community are using market power to leverage the Reserve Bank's 2003 Standard to over-recover the costs of credit card acceptance. There appears to be a case that at least in some instances, the surcharge applied exceeds the difference between the cost of accepting a credit card minus the blended cost of other payment acceptance types.
- ii) I am ambivalent as to whether the Board establishes a cap or the card schemes administer a limit on the size of the surcharge. The key issue is that there should be a cap that relates the surcharge to the appropriate costs. To some extent, this will vary by merchant. The challenging issue would be whether the cap is tied to the merchant service fee or the cost of card acceptance. Given that the major cost in card acceptance apart from the merchant service fee is the tender time (see point iv below), and further that this will be reduced with the expected uptake of contactless cards, I would argue that the cap should be tied to the merchant service fee. Likewise, I would argue that in cases where cards are the only means of effecting payment, they are an inherent component of the sales process and indeed, the business model, and the cap should be limited further to reflect that fact.
- iii) In the absence of any compelling rationale from merchants, I can think of no logic for permitting a tolerance on the surcharge cap. If the logic for determination of the surcharge is recovery of the cost of accepting a credit card minus the blended cost of alternative payment tender, then that should stand. A tolerance would simply become a means of exploiting the surcharge, unless it could be demonstrated that factors such as seasonality or concentration of payments within a period or some other factors caused an ongoing variation to the direct costs.
- iv) The merchant service fee is an obvious choice because it is transparent and relatively straight forward to administer. It at least establishes a baseline for surcharging that would deliver a reasonable expectation that the surcharge reflected the relevant costs. The problem with this logic is that the merchant service fee is just one part of the overall cost of accepting a payment. For example, in the Reserve Bank's November 2007 Payment Costs in Australia Report, the following data was supplied for credit cards, eftpos and cash. These were the weighted average costs for transactions at the average transaction value. Of course, the weighted average cost for cash and eftpos would be largely fixed whilst credit card payments would vary by size.

	Total Weighted Average Cost	Fees Paid to Financial Institutions	Tender Time
Credit Card	\$0.95	\$0.54	\$0.31
Eftpos	\$0.33	\$0.02	\$0.24
Cash	\$0.25	\$0.00	\$0.13

The point of illustrating this is that if a credit card transaction leveraged the emerging contactless technology in which a signature or PIN entry is not required, the tender time which the RBA estimated at 57% of the fees paid to the acquirer, would reduce substantially. So if the

surcharge was linked solely to the merchant service fee, the disincentive to use credit would remain unaltered and work to the detriment of both the merchant and the card issuer if other elements of payment processing are ignored.

- v) The absolute disparity between the average three and four party card scheme fees remains the same today as it was in 2003. In March 2003, the difference between Visa/ MasterCard and American Express was one hundred and eight basis points and in March 2011, it was still one hundred and eight basis points. Whilst there is undoubtedly an administrative advantage for a merchant to blend the three and four party scheme rates, the bottom line is that in such instances, Visa and MasterCard cardholders are subsidising American Express and Diners Club users. It is increasing the disincentive for Visa and MasterCard users to offer their card for payment whilst reducing the disincentive for American Express and Diners Club. For these reasons, I believe the card schemes should have the ability to prohibit blending of card scheme rates.

However, given that a card scheme has the ability to determine differential interchange rates for various products within the scheme whilst operating within the overall weighted average, I think that the schemes should be ambivalent as to whether the acquirer offered a blended rate or specific product rates as requested by the merchant.

- vi) I don't see this as a regulatory issue but as a commercial issue between card acquirers and merchants. The great majority of merchants would not want the complexity of dealing with multiple card fees, preferring the convenience of a blended rate. In such a scenario, both parties bear some risk of an altered product mix. I do not believe that there is a case for mandating the capability for individual BIN rates but if an increasing number of merchants ask for this, competitive pressures will drive acquirers to meet that demand.

Similarly, merchants who now receive interchange plus pricing presumably do so to identify the product mix and because they are able to negotiate a favourable commercial arrangement. If they request a blended rate, that again should be a matter between the merchant and the acquirer rather than a regulatory issue.

- vii) My view is that the current disclosure of the overall average merchant fees is sufficient. I don't see a need for disclosure by merchants of card fees but this view is based upon the Standard being amended to impose a cap on any surcharge with that cap limited to the extent by which the cost of a credit card transaction exceeds the blended cost of other payment options.

Yours sincerely,

Michael Ebstein