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June 30, 2008

Mrs Michele Bullock
Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Email: pysubmissions@rba.gov.au

Dear Mrs Bullock

MasterCard is pleased to provide its response to the Bank on a number of important matters addressed by the Bank in its *Reform of Australia's Payments System – Preliminary Conclusions of the 2007/08 Review* document issued on April 21, 2008.

As always we would be happy to discuss the contents of this submission with you at a mutually convenient time. As I will be transitioning into my new role in Europe over the coming weeks it is best if you liaise directly with Albert Naffah to arrange the necessary consultation meetings.

Sincerely,

A handwritten signature in blue ink, appearing to read "Leigh Clapham".

Leigh Clapham
Executive Vice President – Australasia
MasterCard Worldwide

for

Payments System Regulation

**Response by
MasterCard Worldwide
to the
Preliminary
Conclusions of the
2007/08 Review**

June 30, 2008

Contact persons regarding this response:

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Executive Summary

Of the three options presented for future regulation of Australia's card payment systems in the Reserve Bank's Preliminary Conclusions, MasterCard believes that one of those options is worthy of further consideration – the removal of explicit interchange regulation presented in Option 3 of the Preliminary Conclusions.

MasterCard has long maintained that regulation of interchange fees is both unnecessary and anticompetitive and is willing to participate in the process and pursue a dialogue with the Payments System Board in order that a workable solution under Option 3 may be arrived at.

The Board nevertheless is concerned that, under Option 3, average interchange fees may increase because merchants face a so-called “prisoner's dilemma” situation. This is supposedly because merchants as a group pay more for credit card acceptance than the benefit they receive. Even if this were the case, and MasterCard does not believe that it is, the Board's approach only looks at the benefits to merchants and does not consider the benefits to society as a whole from the use of credit cards. Indeed, the Board has not shown that credit cards do not provide a net benefit to society as a whole.

Moves in the US to deal with the “prisoners-dilemma” issue through legislation seeking to regulate interchange fees have caused the US Department of Justice to warn that these actions may harm consumers rather than benefit them.

MasterCard also believes that the Board's approach greatly undervalues the benefits the merchants receive from accepting credit cards. These include: customer convenience, efficiencies compared to in-house credit cards, avoidance of credit losses and avoidance of bad debts. The benefits of accepting payment credit cards by the world's largest merchant, namely the US government, have been recognized by the US Government Accountability Office in a recent report.

While MasterCard believes that the benefits of the “no-surcharge” rule need to be evaluated on a country-by-country basis, it recognizes in the Australian context that allowing merchants to impose a surcharge for payment card transactions does impose a significant constraint on any potential increase in interchange fees if Option 3 were to be implemented. However, there needs to be protection given to consumers against over-surcharging by merchants particularly where:

- the same level of surcharge is applied by merchants to all credit and charge card transactions – resulting in an over-surcharging of MasterCard and Visa transactions and an under-surcharging of American Express and Diners Club transactions; and

- a uniform surcharge is imposed on all charge, credit and scheme debit transactions, resulting in an over-surcharging of scheme debit transactions.

MasterCard would be willing to consider providing the Bank with an undertaking to allow merchants in Australia to apply surcharges to MasterCard transactions if these consumer protection concerns are able to be dealt with

MasterCard believes that providing merchants with the ability to impose surcharges on payment card transactions will address the Board's concerns about an increase in average interchange fees under Option 3 and that it is not necessary to modify the "Honor-all-Cards" standard so that merchants are allowed to make independent acceptance decisions for each type of card for which a separate interchange fee applies.

If merchants had the ability to refuse acceptance of particular types of credit cards this would undeniably damage the value of the MasterCard brand from both the cardholder's and the merchant's perspective. The flow-on consequences from this course of action could also have unanticipated adverse consequences, for example, with visitors to Australia from overseas carrying premium or commercial cards only to find some merchants rejecting acceptance of those cards.

The Bank relies on cost studies it has undertaken as a basis for regulatory intervention in the payments cards sector. There are a number of reasons why the cost studies undertaken by the Bank are questionable, for example the treatment of capital costs associated with cash usage, and they therefore should not be used as a platform for regulation in this area.

1. Introduction

In April 2008 the Reserve Bank of Australia (**Bank**) published its Reform of Australia's Payments System – Preliminary Conclusions of the 2007/08 Review (**Preliminary Conclusions**).

The Preliminary Conclusions set forth, as its name implies, the Payment System Board's (**Board**) preliminary conclusions of its review of the Bank's regulation of Australia's card payment systems. The Bank sought submissions from interested parties on those conclusions and the Board's analysis set out in the Preliminary Conclusions.

MasterCard is pleased to provide its response to the Bank on a number of important matters concerning the Preliminary Conclusions.

2. Options Regarding Interchange Fees

The Preliminary Conclusions sets forth three options proposed by the Board concerning the regulation of interchange fees.

Of the three options presented, MasterCard believes that only Option 3 is worthy of further consideration, namely, the removal of explicit interchange regulation. While it is clear from the Preliminary Conclusions that further work is required to be undertaken by the Board as to what the parameters of Option 3 would be, MasterCard is willing to participate in the process and pursue a dialogue with the Board in order that a workable solution under Option 3 may be arrived at.

Consideration of an option that removes explicit interchange fee regulation is consistent with views expressed by MasterCard in its August 2007 submission to the Bank:

"MasterCard's review indicates while there may be arguments to support the Bank's 'pro-competitive' interventions having regard to the characteristics of the Australian market, the regulation of interchange fees has been both unnecessary and, indeed, anticompetitive."¹

However, the Board remains concerned that:

"... if Option 3 were implemented and average interchange fees in the credit card systems were to increase materially, the Board would consider reimposition of interchange regulation, probably along the lines of Option 2".²

¹ MasterCard Worldwide, Payments System Regulation – Response by MasterCard Worldwide to the Issues for the 2007/08 Review, August 31, 2007 (August Response)

² Preliminary Conclusions, p.38

The concern indicated above in relation to Option 3 is dealt with in Section 5.1 of the Preliminary Conclusions, where it is noted that:

“A central issue confronting the Review is the extent of the competitive forces acting on interchange fees.”³

The concerns expressed in Section 5.1 rest on three principal assumptions. The first is that: “... in the absence of regulatory oversight, there is a significant risk that interchange fees in some systems will be set at levels that are too high from the point of view of the efficiency of the system.”⁴

The second is that competition among merchants in choosing to accept various means of payments supposedly results in a form of the so-called “prisoners’ dilemma”:

“The main reason for this is that merchants find it difficult to exert sufficient downward pressure on interchange fees, largely as a result of the structure of incentives that they face. In essence, merchants face a co-ordination problem, and as a result are willing to pay more, in aggregate, for some payment methods than the aggregate benefit that they receive from accepting those methods. This difficulty is most apparent in the credit card system but, in principle, can arise in other payment systems as well.

While each merchant that accepts credit cards obviously judges the net benefit of doing so to be positive (otherwise it would not accept credit cards), the aggregate benefit to the merchant community of acceptance need not exceed the aggregate cost of acceptance. This is because part of the benefit that an individual merchant perceives from accepting cards is that of ‘stealing’ business from other merchants.”⁵

The third assumption is that this prisoners’ dilemma creates an economic distortion:

“The Board’s central conclusion here is that merchants, as a group, will pay more for credit card acceptance than the benefit they receive, introducing a distortion into the system.”⁶

The argument presented by the Board in Section 5.1 of the Preliminary Conclusions merits careful examination.

While we strongly disagree with the notion that “business stealing” is the only benefit derived by merchants that accept credit cards, and we address this in section 3 below, we focus our attention in this section on the Board’s application of the prisoner’s dilemma.

³ *Ibid* p.15

⁴ *Ibid*

⁵ Preliminary Conclusions, p.15

⁶ Preliminary Conclusions, p.16

Although it is possible to characterise competition as a form of prisoners' dilemma, it is quite unorthodox to define economic efficiency and economic distortions in terms of the net benefits to a limited section of society, such as merchants. This is simply the wrong test. The standard test for economic efficiency is to add up the net costs and benefits to all members of society. There is simply no good reason to examine the net benefits to merchants as a group and exclude other benefits to society. Put simply, it may be true that some merchants are forced as a result of competition to pay more for a particular form of payment than they would prefer, but this is the result of competition between merchants, not a competition distorting effect. In fact, the same could be said of any of the myriad of consumer friendly services that merchants provide, such as free parking and longer store hours.

The equilibrium of a prisoners' dilemma game is that the individual actions of each results in an outcome whereby each has a lower level of welfare than if they had been able to follow the joint-maximising strategy. If the interests of consumers are taken into account, competition ceases to be a prisoners' dilemma. If the Board wishes to argue that credit cards are inefficient or are a distortion, they have to show that they impose a net cost on society as a whole⁷ not just on one section, namely, the merchants. The Board has not done this.

In the United States a Bill (H.R. 5546, *Credit Card Fair Fee Act of 2008*) has been proposed which deals with the prisoner's dilemma issue referred to by the Board (as indicated above) by creating a broad immunity under the antitrust laws for merchants and issuers jointly to negotiate interchange fees and terms of access to a credit and/or debit card network above a certain size. For merchants and issuers that are unable to reach agreement, the Bill establishes a panel of judges that will establish interchange fees and terms of access. The comments of the U.S. Department of Justice (DoJ)⁸ are illuminating in this regard:

"... this bill may actually harm to consumers (sic), not benefit them. The credit and debit card markets are complex, so-called 'two-sided' markets in that each network needs to attract both cardholders and merchants. Pricing on one side of the market impacts the pricing on the other side. For example, newspapers charge less to readers in order to increase sales and circulation, thereby making their paper more attractive to advertisers. Revenues from advertisers support the lower prices to readers. Similarly, credit card networks forced by regulation to collect less from merchants may well respond by charging more to cardholders in card fees, or reducing card reward programs and other features that are attractive to consumers."

⁷ Another social benefit card payments deliver to an economy is the reduction in the "shadow" or "black" economy that thrives on the use of cash for consumer payments.

⁸ Letter from Keith B. Nelson, Principal Deputy Assistant Attorney General, Department of Justice to The Honorable Lamar Smith, Ranking Member, Committee on the Judiciary, U.S. House of Representatives dated June 23, 2008

The DoJ also notes:

“...suppressing competition pursuant to what is essentially price-control legislation is likely to be inefficient and costly, thereby harming consumers.”

A copy of the DoJ letter and the letter from the U.S. Federal Trade Commission are provided in Annexure A

3. Benefits of Credit Card Acceptance for Merchants

As indicated in Section 2 above, the Board has mistakenly sought to identify a net cost for merchants arising from credit card acceptance due to the “prisoners’ dilemma” effect. Implicit in the Board’s approach is the assumption that merchants may in aggregate potentially pay more for credit card acceptance than the benefits they receive.

This approach under values the benefits that merchants receive from credit card acceptance. The Board is aware that payment cards were created by merchants to enhance their own profitability by providing a convenient way for their customers to pay. However, merchant’s in-house payment card systems proved inefficient, because each merchant had to market and issue its own cards, process and evaluate which of its customers were credit worthy, provide customer service, incur the costs of funding the transactions, establish and maintain debt collection programs and bear credit losses.

By choosing to accept payment cards issued by third-party credit card schemes, such as MasterCard, merchants are able to increase revenues and make sales on credit without taking on credit risk. The fact that many large retailers have converted their in-house credit cards to payment cards run by third-party schemes, such as MasterCard, is evidence that the benefits to merchants from credit card acceptance outweighs the amount they pay for credit card acceptance.

The most recent evidence of the benefits to merchants arising from credit card acceptance is the report of the US Government Accountability Office (GAO) on Credit and Debit Cards.⁹ This report concerned, amongst other things, the benefits and costs associated with one of the world’s largest merchant’s, namely the US government’s, acceptance of credit and debit cards. The report noted:

“Federal entities realise various benefits from accepting credit and debit cards, but also incur various costs, including merchant discount and interchange fees, which they are taking steps to control. Federal entity officials told us that the benefits of accepting cards

⁹ United States Government Accountability Office, *Credit and Debit Cards – Report to Congressional Requesters*, May 2008

include more satisfied customers, fewer bad checks and cash thefts, and improved operational efficiency. In fiscal year 2007, federal entities collected a total of \$27 billion in revenues through credit and debit card transactions and reported paying at least \$433 million in merchant discount fees, which include interchange fees associated with Visa and MasterCard transactions.”¹⁰

While the GAO did view the Bank’s mandated reduction in interchange fees as being a benefit for merchants, the same conclusion could not readily be drawn so far as consumers were concerned:

“Research on the impact of the regulation of interchange fees in Australia in 2003 indicates that merchants have likely benefited, as the total merchant discount fees they pay have decreased. However, evidence suggests that the impact on cardholders in that country has been mixed: Australian regulators have not been able to discern whether merchants passed along any reduction in costs to consumers through lower prices. However, issuing banks generally have reduced the rewards offered on reward cards and increased annual and other card fees over the last 5 years.”¹¹

Furthermore, four-party payment card schemes allow small merchants, which historically have not had the scale or sophistication required to develop and support a store card program, to better compete with larger merchants by enabling them to outsource the provision of credit to their customers.

4. Surcharging

As MasterCard indicated in its August Response, the costs and benefits of a “no surcharge” rule need to be balanced and, for that reason, MasterCard ordinarily considers the question of whether to maintain the “no surcharge” rule on a country-by-country basis:

“Nonetheless, MasterCard also recognises the possible benefits in the Australian context of increasing merchants’ pricing flexibility, and that surcharging provides four-party schemes with yet another basis to ensure that the level of interchange fees does not exceed merchant willingness to pay.”¹²

MasterCard believes that the ability of merchants to impose a surcharge places a significant constraint on any potential increase in interchange fees if the Bank were to step-back from interchange fee setting regulation under Option 3. Comments in the Preliminary Conclusions support this view:

¹⁰ *Ibid* at p.5

¹¹ *Ibid* at p. 6

¹² August Response at p.16

“Confidential data from one card scheme indicate that when surcharges are imposed on a particular type of card, use of that card declines substantially. Where merchants have imposed a surcharge on one scheme only, or imposed a higher surcharge on one scheme than another, there have been large shifts in payment patterns away from the scheme with higher surcharges.”¹³

While MasterCard accepts that, in the context of consideration of Option 3, the ability of merchants to impose a surcharge on particular types of payment cards does place an effective constraint on the setting of interchange fees, MasterCard believes that there does need to be some protection given to consumers against over-surcharging by merchants. The problem was identified by CRA International in its submission to the Bank:

“Whereas the RBA expected surcharging to be cost-based, the schemes expected merchants to use surcharging as a means of price discriminating against consumers who used payment cards. The schemes expected merchants to attempt to use surcharging as a means of capturing some of the value that would otherwise be derived by consumers from the use of payment cards.

The available evidence on surcharging in Australia reveals that, in line with the schemes’ expectations, surcharging on average has not been cost-based: merchants on average appear to set surcharges on Visa and MasterCard transactions that are greater than merchant service charges. The January 2007 East & Partners survey indicates that the average surcharge for Visa and MasterCard transactions to be approximately 1%, 15 basis points higher than the average merchant service charge in December 2006. An earlier survey conducted by Cannex found that the average surcharge for Visa and MasterCard transactions was 1.8%, approximately 81 basis points higher than the average merchant service charge in December 2004”.¹⁴

MasterCard believes that the Bank should allow the schemes to place constraints on the ability of merchants to impose surcharges so that any such surcharging is in line with the cost-based surcharging expectations of the Bank. This would then restrict merchants from using surcharging as a means of capturing value that would be otherwise derived by consumers from the use of payment cards. There are two situations where this over-surcharging is prevalent:

- where a uniform surcharge is applied by merchants to all credit and charge card transactions – which results in an over-surcharging of MasterCard and Visa transactions and an under-surcharging of American Express and Diners Club transactions, having

¹³ Preliminary Conclusions at p.18

¹⁴ CRA International, *Regulatory intervention in the payment card industry by the Reserve Bank of Australia – Analysis of the Evidence*, April 2008 (CRA) at pp 27-28

regard to the higher merchant service fee charged by American Express/Diners Club to that charged in respect of MasterCard/Visa transactions; and

- where a uniform surcharge is imposed on all charge, credit and scheme debit transactions, resulting in an over-surcharging of scheme debit transactions.

In the Preliminary Conclusions it was indicated that the Board would be:

“... prepared to consider removing the [no-surcharge] Standard if the schemes provided an enforceable undertaking that they would alter their rules to allow surcharging.”

As the Bank is aware, MasterCard has provided an enforceable undertaking concerning its honor-all-cards rule. MasterCard would be willing to consider providing the Bank with an undertaking to allow merchants in Australia to apply surcharges to MasterCard transactions if the consumer protection concerns identified above are able to be dealt with.¹⁵

MasterCard believes that the Bank’s payment systems regulations should be directed to the wider public good rather than a particular section of the public, namely, the merchants. While merchants have undoubtedly benefited from the mandated reduction in interchange fees, it has not been demonstrated that there has been a wider public benefit resulting from this regulation. There is certainly no evidence that the benefits obtained by merchants from lower interchange fees have been passed on to consumers in the form of lower prices at the cash register.

As CRA points out:

“... the fact remains that no evidence has been presented that would allow one to conclude that the undeniable losses to cardholders have been offset by reductions in retail prices or improvement in the quality of retail service. In contrast, we know with confidence that merchants have been the beneficiaries of the RBA’s intervention. We know this from the fact that merchants were in favour of the past reductions in interchange fees and now would like even further reductions. It is extremely unlikely that merchants would be taking this position if reductions in merchant service charges resulting from the RBA’s regulations were simply passed through to consumers in the form of lower prices and/or higher quality service.”¹⁶

The Bank has estimated that over the past year the cost savings to merchants from lower merchant service fees is in the order of \$1.1 billion (amounting to more than \$6.5 Billion over the last 5 years)

¹⁵ MasterCard proposes to base such undertaking on its no surcharge rule in Europe, which permits merchants to surcharge as long as (i) the merchant clearly indicates to its customer prior to the sale the amount of the surcharge or how it will be calculated and (ii) the amount of the surcharge is reasonably related to the merchant’s cost of accepting the card.

¹⁶ CRA at p.33

although “no concrete evidence has been presented to the Board regarding the pass-through of these savings...”.¹⁷

5. Honor-all-Cards Standard

In its August Response MasterCard stated:

*“One of the essential requirements of a four-party scheme is that it must ensure that a card issued by any issuer can be used at a merchant acquired by any acquirer. This requirement goes to the core of the scheme as it guarantees issuer equality of excess and ensures consumers of the ubiquity of the card.”*¹⁸

MasterCard is disappointed that in the Preliminary Conclusions the Board has concluded that the Honor-all-Cards Standard should be:

- (i) modified so as to prevent schemes offering a discounted interchange fee to a merchant on the condition that they accept all of the scheme’s cards;¹⁹ and
- (ii) in the context of Option 3, modified so as to “allow merchants to make independent acceptance decisions for each type of card for which a separate interchange fee applies. This would allow a merchant to refuse acceptance of, say, premium cards if it thought the cost of acceptance was too high relative to the benefit gained”.²⁰

In relation to the first point, MasterCard does not see what the public interest concern is in relation to offering merchants a discount if they accept all of a scheme’s cards. It is akin to a discount offered by a supplier to any merchant if that merchant carries a number of the supplier’s products. Merchants are still free to choose whether or not to accept the discount and whether to thereby acquire that supplier’s products. The merchant is better off as a result. Whether the merchant’s customers are better off depends on whether the savings are passed on by the merchant. The Bank is clearly of the view that such savings are passed on.

In relation to the second point, MasterCard would be extremely concerned if merchants had the ability to refuse acceptance of particular types of cards. For reasons spelled out at length in the August Response, such a modification to the Honor-all-Cards Standard “would undeniably damage the value of the MasterCard brand from the cardholder’s and merchant’s perspective”.²¹ The flow-on consequences from this course of action could also have unanticipated adverse consequences. For example, visitors to Australia from overseas carrying premium or commercial cards may find

¹⁷ Preliminary Conclusions at p.23

¹⁸ August Response at p.22

¹⁹ *Ibid* at p.27

²⁰ *Ibid* at p.33

²¹ August Response at p.22

some merchants rejecting acceptance of those cards. This would not help efforts to promote Australia as a tourist destination or one which is favourable to international business travellers who are heavily reliant on premium or commercial cards.

While MasterCard understands that the Board is concerned that, in the context of Option 3, steps be taken “to improve the ability of merchants to put downward pressure on interchange fees”²², for the reasons indicated in Section 4 above, providing merchants with the ability to impose differential surcharging which is reflective of the cost of accepting difference types of cards, should provide the required downward pressure.

6. Price Signals

The Board makes clear its view that the Bank’s regulations:

*“... have met a key objective of improving the price signals that consumers face when choosing between use of credit and debit cards. In particular, the relative prices that consumers face for credit and debit transactions more closely reflect relative costs than was the case prior to the reforms”.*²³

An important determinant of the Board’s views in this regard have been the studies undertaken by the Bank concerning the costs of various payment instruments.

We have asked Frontier Economics to conduct a review of the cost and usage research released by the Bank in November 2007. That review raised two fundamental conceptual issues concerning the Bank’s research:

- (i) how to estimate the costs of providing a particular means of payment provided by a multi-product firm, for example, where some of the products are provided by the joint activity of two or three firms. Some of the cost estimates provided in the Bank’s research must accordingly be treated with caution. For example, there is no information provided in the Bank’s research of the capital costs that are incurred by the economy as a result of using cash as a means of payment. Accordingly, there needs to be considerable caution in drawing any inferences from the research about the relative costs of cash compared with other means of payment; and
- (ii) which costs to include and whether an item of expenditure is classified as a “resource cost” and not counted or whether it is classified as a “transfer cost” and not counted. Many of the estimates are highly sensitive to how an item of

²² Preliminary Conclusions at p.33

²³ Preliminary Conclusions at p.17

expenditure is classified and some of the classifications adopted in the research seem quite arbitrary.

The fact that the Bank is designing significant regulations on the basis of payments cost research that is questionable is of concern. Some of these concerns have also been raised by CRA, for example:

“The fact that the updated study in 2007 has arrived at inflation-adjusted cost estimates that are so much lower than the cost estimates in the original Joint Study inevitably raises questions regarding the quality of the estimates. The RBA has not tried to explain this difference in its cost estimates, and it is improbable that there truly were changes in cost conditions that can explain the difference between the original Joint Study and updated cost estimates. If we are to accept the updated estimates, the natural conclusion is that the cost estimates in the original Joint Study – the study on which the RBA based its decision to intervene – were very significantly overstated.”

“... even if one accepts the accuracy of the updated cost estimates (which, for reasons explained below, we do not) the updated cost estimates imply that the RBA should regard its case for intervening in the payment card industry as significantly weaker than the case it thought it had in 2003 based on the cost calculations in the Joint Study.”²⁴

The difficulty of relying on the Bank’s cost research as a basis for the making of significant policy decisions is also questionable in view of future developments which will reduce the costs associated with the use of payment cards. These include:

- PIN @ POS – which will require the cardholder to log a PIN at the merchant’s terminal in order for the transaction to proceed as opposed to signing a receipt in order for the transaction to proceed. Amongst other benefits, this will significantly speed up the transaction and reduce the tender time of a transaction involving a scheme issued payment card.
- EMV/chip cards – which enables cards to be more secure than those that have magnetic stripes and which are susceptible to being copied and used for fraudulent transactions. EMV/chip cards have chips which use encryption algorithms to provide authentication of the card to the processing terminal and the transaction processing centre. Combined with PIN@POS – these cards will enable a significant reduction in fraud costs – particularly in the case of “offline” credit card transactions.

²⁴ CRI at p.52

7. Other Issues

The Preliminary Conclusions raised a number of other issues including:

- (i) publication of scheme fees paid by issuers and acquirers;²⁵ and
- (ii) publication by schemes of their weighted-average interchange fees on a quarterly basis.²⁶

MasterCard is willing to discuss these matters further with the Bank in the interests of arriving at a solution that is acceptable to both the Bank and to MasterCard.

8. Conclusion

MasterCard remains of the view that four-party payment card schemes operating in a free market are better able to deliver value to merchants and consumers the world over.

Notwithstanding the above, as we have set out in this submission, MasterCard is willing to work with the Bank and the industry to help deliver an outcome that fundamentally allows the industry to regulate its own business. To that extent, Option 3 is the only option that MasterCard is able to support, but that support is subject to the establishment of conditions that deliver true and lasting self-regulation.

²⁵ Preliminary Conclusions at p.30

²⁶ *Ibid*

Annexure A

1. Letter from Keith B. Nelson, Principal Deputy Assistant Attorney General, Department of Justice to The Honorable Lamar Smith, Ranking Member, Committee on the Judiciary, U.S. House of Representatives dated June 23, 2008
2. Letter from William E. Kovacic, Chairman, U.S. Federal Trade Commission, to The Honorable Lamar Smith, Ranking Member, Committee on the Judiciary, U.S. House of Representatives dated June 19, 2008



U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

June 23, 2008

The Honorable Lamar Smith
Ranking Member
Committee on the Judiciary
United States House of Representatives
Washington, D.C. 20515

Dear Congressman Smith:

This responds to your letter, dated June 2, 2008, requesting the Department of Justice's views on H.R. 5546, the "Credit Card Fair Fee Act of 2008". We appreciate the opportunity to provide the Department's views.

Section 2(c) of this bill creates a broad immunity under the antitrust laws for merchants and issuers jointly to negotiate interchange fees and terms of access to a credit and/or debit card network above a certain size. For all merchants and issuers that are unable to reach agreement, section 3 of the bill establishes a panel of Electronic Payment System Judges that will establish access rates and terms. The Payment System Judges are to be appointed and supported by the Antitrust Division and the Federal Trade Commission Bureau of Competition, an arrangement that the Department believes conflicts with the Appointments Clause, as discussed further below.

The antitrust laws are the chief legal protector of the free-market principles on which the American economy is based. Companies free from competitive pressures have incentives to raise prices, reduce output, and limit investments in expansion and innovation to the detriment of the American consumer. Accordingly, the Department has historically opposed efforts to create sector-specific exemptions from the antitrust laws. The Department believes that antitrust exemptions can be justified only in very rare instances, when the fundamental free-market values underlying the antitrust laws are compellingly outweighed by a clearly paramount and clearly incompatible public policy objective. Moreover, any such legislation establishing an antitrust exemption should be narrowly drawn and carefully tailored to avoid unintended consequences. Consequently, the Department has serious concerns about this legislation for a variety of reasons.

First, this bill may actually harm to consumers, not benefit them. The credit and debit card markets are complex, so-called "two-sided" markets in that each network needs to attract both cardholders and merchants. Pricing on one side of the market impacts the pricing on the other side. For example, newspapers charge less to readers in order to increase sales and circulation, thereby making their paper more attractive to advertisers. Revenues from advertisers support the lower prices to readers. Similarly, credit card networks forced by regulation to collect less from merchants may well respond by charging more to cardholders in card fees, or reducing card rewards programs and other features that are attractive to consumers. Indeed, a recent GAO Report, *Credit and Debit Cards*, GAO-08-558 (May 2008), suggests this may be what happened in Australia when Visa and MasterCard's interchange rates were capped. The

GAO reported that “consumers have experienced a decline in the value of credit card reward points for most cards and an increase in annual and other consumer credit card fees.” GAO Report at 35. Although there remains the important question of whether consumers paid sufficiently less for credit card purchases to compensate for these effects, the GAO Report does raise questions regarding whether legislation regulating rates on one side of the network would benefit competition and consumers.

Second, the bill seeks to counter perceived market power on the part of large credit card networks by establishing market power on the part of merchants negotiating with those networks. It would do this by exempting from the antitrust laws joint negotiations of merchants with any network electronic payment system that has been used for at least 20% of the combined dollar value of U.S. credit, signature-based debit, and PIN-based debit card payments. From a policy perspective, the Department does not support legislatively establishing a buy-side monopoly (or monopsony) to counteract any existing market power. Such a result may well increase, not decrease any existing harm to competition and consumers. Indeed, the joint negotiations among merchants exempted by the bill appear to be the type of naked collusion that the antitrust laws condemn as per se unlawful because such conduct lacks plausible benefits to competition. Moreover, the ability of merchants (and issuers) to discuss, jointly negotiate, and agree upon fees and terms with one network could lead to an implicit understanding on what fees and terms to accept from other networks, including networks not encompassed by this legislation. Such a spillover effect would diminish, not enhance, competition between payment card networks, which is the best and most productive way to ensure that consumers are protected and benefitted.

Third, suppressing competition pursuant to what is essentially price-control legislation is likely to be inefficient and costly, thereby harming consumers. Section 3 of this bill creates a panel of Electronic Payment System Judges that would resolve disputes if issuers and merchants were unable to voluntarily reach a jointly-negotiated agreement. The Department does not support the creation of a regulatory panel to set rates and terms of access. Generally, regulation should be confined to the fewest areas possible, and even then should be narrowly tailored to address a clearly demonstrated market failure. Notwithstanding the best of intentions and goals, the regulator will be imperfect in its attempt to replicate the terms that would be reached in a competitive market. Moreover, a panel of regulators cannot replicate the flexibility that is found in the free market. This bill imposes inflexibility into the terms and fees by requiring all terms to apply across all merchants and issuers that do not reach an agreement and by setting the same fee and terms for a period of two or three years.

Fourth, the Department believes that the method of appointment of Payment System Judges in section 3 conflicts with the Appointments Clause. By giving Payment System Judges authority to issue binding decisions setting rates and terms of access to credit card networks, as well as authority to assess civil penalties for failure to comply with collateral orders, the bill appears to vest a portion of the sovereign authority in the Payment System Judges, making them “Officers of the United States” for purposes of the Appointments Clause. *See Memorandum*

Opinion for the General Counsels of the Executive Branch, *Officers of the United States Within the Meaning of the Appointments Clause* at 1, 12-13 (Apr. 16, 2007), available at <http://www.usdoj.gov/olc/2007/appointmentsclausev10.pdf> (“delegated sovereign authority . . . is power lawfully conferred by the Government to bind third parties,” and includes power to “issue regulations and authoritative legal opinions” and “impose penalties”). The Payment System Judges would likely be inferior, rather than principal officers, because the bill gives the Antitrust Division and Federal Trade Commission Bureau of Competition authority to sanction or remove Payment System Judges; accordingly, Congress may only vest authority to appoint these officers “in the President alone, in the Courts of Law, or in the Heads of Departments.” U.S. Const. art. II, § 2, cl. 2; see *Edmond v. United States*, 520 U.S. 651, 662-63 (1997) (stating, as a general rule, that “‘inferior officers’ are officers whose work is directed and supervised at some level by others who were appointed by Presidential nomination with the advice and consent of the Senate”). The Antitrust Division and Federal Trade Commission Bureau of Competition do not fall within any of these categories and therefore may not statutorily be granted authority to appoint the Payment System Judges.

In addition to these constitutional concerns, the process outlined in sections 3 and 4 of this bill imposes significant burdens on the Antitrust Division and the Federal Trade Commission Bureau of Competition. This bill requires the Antitrust Division to consult with Payment System judges and issue or approve regulations relating to proceedings. The Antitrust Division is a law enforcement agency. It has not performed these functions in the past, does not have the resources to do so currently, and such a requirement likely would detract from the Division’s law enforcement mission. The administrative support the agencies are expected to provide the Electronic Payment System judges—by, for example, representing the tribunal of judges before the Circuit Court—is likely to impose substantial burdens, as litigation is almost certain to arise from any decisions of the tribunal and is likely to be extensive and complicated.

For the foregoing reasons, the Department has serious concerns about this bill and the burdens the bill imposes on the Antitrust Division and the Federal Trade Commission Bureau of Competition.

Please do not hesitate to call upon us if we may be of additional assistance. The Office of Management and Budget has advised us that from the perspective of the Administration's program, there is no objection to submission of this letter.

Sincerely,



Keith B. Nelson
Principal Deputy Assistant Attorney General

cc: The Honorable John Conyers, Jr.
Chairman



THE CHAIRMAN

FEDERAL TRADE COMMISSION

WASHINGTON, D.C. 20580

June 19, 2008

The Honorable Lamar Smith
Ranking Member
Committee on the Judiciary
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Smith:

Thank you for your letter of June 2, 2008, requesting views on H.R. 5546, the Credit Card Fair Fee Act of 2008, which was introduced on March 6, 2008, by Chairman Conyers and thirteen co-sponsors. In particular, you request views on the advisability of the bill's approach and its potential administrative burden for the Commission.

H.R. 5546 would grant an antitrust exemption to banks and merchants to negotiate jointly the interchange rates and terms for merchants' access to a consumer credit card payment system of a certain size. Further, if the joint negotiation between banks and merchants does not produce an agreement on interchange rates and related terms, the merchants and banks would be subject to an administrative procedure before a three-judge panel to determine the rates and terms for a three-year period. The three-judge panel would be selected and administered by the Department of Justice's Antitrust Division and the Commission according to a detailed process specified in the bill.

Based on the agency's general expertise in competition matters, I can offer a few global comments. As you know, however, under its longstanding agreement with the Antitrust Division, the Commission and the Antitrust Division coordinate their antitrust actions to avoid duplication and maximize the effectiveness of federal antitrust enforcement. The Antitrust Division for many years has handled antitrust oversight of financial services markets, and I defer to the Antitrust Division as to the merits of the proposed legislation.

As a general matter, the Commission has long disfavored exemptions from the antitrust laws. As you know, the Antitrust Modernization Commission ("AMC") reiterated what most scholars have believed for years, that exemptions from the antitrust law should be disfavored, and urged that Congress exercise caution.¹ Accordingly, the AMC recommended that such

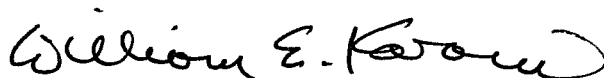
¹ Antitrust Modernization Commission, Report and Recommendations (April 2007), available at http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf

statutory immunities be granted “rarely” and only where proponents have made a “clear case” that exempting otherwise unlawful conduct is “necessary to satisfy a specific societal goal that trumps the benefit of a free market to consumers and the U.S. economy in general.”² For many years it has been the Federal Trade Commission's view that proponents of setting aside competitive forces should bear a heavy burden of demonstrating, with factually-supported reasons, the need for a departure from the nation's competitive model.

With respect to administrative burden on the Commission itself, I note particularly that a governmental process for setting prices for private transactions is at odds with the Commission's mission and experience in promoting open market competition. In addition, assigning the administrative responsibilities jointly to two agencies could further complicate this task.

If you or your staff have questions, please contact Jeanne Bumpus, the Director of our Office of Congressional Relations, at (202) 326-2195.

Sincerely,

A handwritten signature in black ink that reads "William E. Kovacic". The signature is written in a cursive style with a large, sweeping "W" and "K".

William E. Kovacic
Chairman