

WOOLWORTHS LIMITED

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30 June 2008

Ms Michele Bullock
Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

Dear Michele,

Re. Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review

Woolworths Limited (Woolworths) makes the following comments in response to the Reserve Bank of Australia's (RBA) media release on 21 April 2008. This release requested submissions concerning the RBA's preliminary conclusions from its 2007/08 Review. Woolworths makes these comments separately from the Australian Merchant Payments Forum's (AMPF) submission. Woolworths is a member of AMPF, and endorses the comments contained in the AMPF submission.

Woolworths is Australia's leading retail group, with annual sales of over \$40 billion. Woolworths is a self-acquirer of EFTPOS transactions, a member of the Consumer Electronic Clearing System (CECS) Management Committee, and a very active participant in Australia's card payments industry.

Australia's payments system has clearly benefited from the reforms introduced by the RBA. Anti-competitive restrictions have been lifted, market access has been broadened, transparency and understanding of underlying costs has improved, and price signals to consumers now better reflect the underlying costs of payments instruments.

The efficiencies gained as a result of the RBA's reforms to date would never have been achieved but for the RBA's intervention. Potential exists for the realisation of further efficiency gains from Australia's payments system, and Woolworths calls upon the RBA to continue to extract these efficiencies.

Unexpectedly, the RBA's latest guidance demonstrates a significant change in their approach to regulation. Woolworths fears that the benefits realised to date as a result of the RBA's reforms will be eroded if the RBA steps back and allows industry participants - mainly financial institutions and card schemes - to govern the cards market. This is because the cards market is heavily imbalanced with the majority of participants' interests closely aligned with the best interests of card issuers, and not necessarily the best interests of the payments system.

The latest RBA proposals are risky and could result in the payments system reverting towards its pre-regulatory climate.



1 RBA's Proposed Interchange Options

Woolworths maintains that card payments in Australia should not be subjected to an interchange fee, just as ATM transactions in Australia are moving to nil interchange. There is no valid reason for maintaining an interchange fee in an established cards market. 'User pays' is a more appropriate principle of recovering any costs incurred in operating Australia's cards market, rather than continuing the practice of cross-subsidisation via interchange fees.

Interchange fees remain unjustified and are unrelated to any fundamental costs. Many payments systems around the world, card-based or otherwise, operate successfully without interchange fees. The arguments recently put to the RBA for self regulation of interchange fees by certain industry participants failed to reason why an interchange fee is needed to begin with. There is no reason to continue the practice of levying interchange fees on card transactions.

Woolworths questions why it should fund, via interchange, the cost of marketing programs operated by financial institutions to attract cardholders. It is a financial institution's responsibility to charge its cardholders directly for any benefits or services provided.

1.1 Credit Cards

Woolworths' concerns about the prospects of a competitive marketplace for credit card interchange are shared by the RBA. To avoid reprinting these references, they can be found on pages 15, 16, 21, 22 and 36 of *Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review*.

Current levels of competition in the credit card market are inadequate to prevent weighted average interchange fees from exceeding the current RBA benchmark. This is a result of the increasing number of cards on issue that attract premium interchange rates. It is only the RBA's regulations that are preventing weighted average interchange fees from increasing further. Interchange fees have a natural tendency to increase because they enable a card scheme and its issuers to promote their products more effectively. Based on this, Woolworths can not understand why the RBA is contemplating withdrawing its interchange Standards.

Furthermore, given the RBA's position that "the current difference in interchange fees in the credit and debit card systems is significantly higher than could reasonably be justified by [the arguments put to the RBA]"¹, it is difficult to reconcile the RBA's willingness to allow self regulation to deliver non-"material"² increases in credit card interchange fees.

If the RBA's self regulatory Option 3 is implemented, Woolworths does not expect any meaningful improvements in competition that would lead to a reduction in credit card interchange fees. Woolworths does not believe that a stronger EFTPOS network will have any real impact on credit card interchange fees. Similarly, the prevalence of surcharging is unlikely to move from its current trend unless average merchant service fees change dramatically. Regardless, many merchants that currently apply a card surcharge do not at present surcharge Visa and MasterCard credit products.

¹ P.32, *Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

² P.38, *Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

The probable outcome of self regulation is that weighted average credit card interchange fees will be set as high as possible without requiring the RBA to reintervene. Woolworths recommends that the RBA exclude credit card interchange fees from any possible self regulation. The RBA's proposed 30bp credit card interchange benchmark³ is a better outcome for Australia's payments system than self regulation of credit card interchange fees.

1.2 Debit Cards – Government Regulation

EFTPOS is Woolworths' most commonly used means of card payment. Woolworths' customers' preference for making card payments by EFTPOS demonstrates that there is no risk to the existence of EFTPOS stemming from consumer demand. EFTPOS as a card product is at a disadvantage to Scheme debit cards because of the considerable gap between Scheme debit and EFTPOS interchange. As a result, debit card issuers have an incentive to issue Scheme debit cards.

Woolworths maintains that a nil interchange environment for *all* card payments is the best means of aligning interchange rates for all debit cards. Nil interchange would also address the misaligned price signals facing users of debit and credit cards. Under nil interchange, card products would be offered on a 'user pays' basis rather than receiving varying levels of cross subsidisation.

Woolworths implores that any regulation of debit card interchange fees should reflect that debit card payments are made using the cardholder's funds. Accordingly, debit cards should mirror cash and direct entry payments which involve no interchange fees.

The RBA has proposed that it will introduce a weighted average interchange cap of five cents per transaction payable to the issuer for all debit card transactions if its preferred outcome of self regulation proves unviable. Woolworths can not find any merit in the magnitude or the direction of this proposed interchange cap. As a close substitute for cash, consumers do not require an incentive to make debit cards payments. And financial institutions currently levy account keeping charges to recoup their costs of offering debit cards. Hence there is no need to introduce a debit card interchange fee payable to card issuers to entice either cardholders or card issuers.

Financial institutions currently, and will continue to, issue debit cards that do not receive interchange fees. Introducing an interchange fee on all debit card transactions payable to the issuer creates an additional and unnecessary cost for merchants.

The potential introduction of a debit card interchange fee payable to the issuer appears to be at odds with previous RBA reforms.

1.3 Debit Cards – Self Regulation

The market for debit cards consists of two different product categories; EFTPOS and Scheme debit cards. Through the removal of the Honour All Cards Rule (HACR), the RBA has enabled merchants to route Scheme debit transactions via the EFTPOS network for processing. This option for merchants should ensure that Scheme debit interchange fees for card present transactions do not significantly exceed EFTPOS interchange fees. Accordingly,

³ Many large Australian merchants are currently paying an interchange rate of 30-34bp for a large proportion of their credit card transactions.

competition between the two categories of debit cards should prevent Scheme debit interchange fees from ‘pulling up’ EFTPOS interchange fees. However, there is no similar competitive safeguard to prevent undue increases in EFTPOS interchange fees from ‘pulling up’ Scheme debit interchange fees.

For card schemes and their members, and also the majority of potential EFTPOS Scheme members, high debit card interchange fees payable to the card issuer are favourable. Accordingly, there is no guarantee that multilateral EFTPOS interchange fees won’t be subject to upwards pressure if the EFTPOS Scheme comes to fruition. Should self regulation eventuate, any multilateral interchange fees set by the EFTPOS Scheme should be cost-based, transparent and monitored by the RBA.

There exists some, if limited, competition between the two categories of debit cards. If self regulation of interchange fees is to be trialled by the RBA, the scope of this trial should be limited to debit cards.

Self regulation, if used appropriately, is an effective way of dealing with technical and operational issues affecting card networks. Experiences prior to the RBA’s card market interventions, and even current market outcomes, suggest that self regulation struggles to deliver outcomes that are in the best interests of the payments system for issues concerning interchange, card acceptance and surcharging.

2 Interchange Benchmark Compliance

Woolworths supports the RBA’s conclusion that interchange benchmark compliance should be required on an annual basis. The current requirement of three-yearly compliance with interchange benchmarks provides considerable scope for Schemes’ weighted average interchange fees to creep above the benchmark. This undermines the effectiveness of the RBA’s interchange Standards.

3 EFTPOS Scheme

3.1 Innovation

The RBA’s reasoning for proposing an interchange cap of five cents per transaction applicable to all debit cards and payable to the issuer is that it “could potentially allow the schemes to use interchange fees in a way that promotes innovation in the system”⁴. However, the RBA has also concluded that its reforms, which include regulated reductions to credit card interchange fees, “have had little effect on the pace of innovation”⁵. These two conclusions seem to contradict one another.

Woolworths postulates that innovation is not stimulated by higher interchange fees. After all, Australia’s cards market experienced very few new developments prior to the RBA’s intervention, when interchange fees were unregulated and significantly higher than at present. Furthermore, high interchange card markets overseas do not necessarily exhibit higher rates of innovation. This is supported by the RBA observation that the roll out of chip and PIN has

⁴ P.31, *Reform of Australia’s Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

⁵ P.24, *Reform of Australia’s Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

not been hastened in high interchange markets; “countries with higher interchange fees than Australia, most notably the United States, have not upgraded to chip and PIN”⁶.

In fact, Woolworths believes that the frequency of innovation in the Australian cards market has increased since the RBA first regulated credit card interchange fees. Since interchange regulation commenced, the cards market has witnessed the introduction of ‘low-rate’ credit cards, PIN authorisation of credit cards, prepaid and gift cards, EMV, Triple DES and contactless payment trials.

As a self acquirer of card payments, Woolworths is aggrieved by the notion that interchange fees payable to the issuer are an appropriate means of funding network developments. After all, both acquirers and issuers typically incur costs in any network developments, and it is unreasonable that acquirers should fund their own development costs and also subsidise the development costs of issuers. The RBA also arrived at a similar conclusion; “raising interchange fees paid by acquirers would not seem to be consistent with encouraging those same acquirers to undertake significant additional capital expenditure”⁷. Since payment of interchange fees is a ‘zero sum game’, any use of interchange fees to subsidise the development costs of one side of the market places a burden on the other side of the market.

Any funding of developments to debit card networks should be met by means other than interchange. Otherwise, an inflated interchange fee will be levied indefinitely regardless of whether development costs have been recovered, or even incurred.

3.2 Network Development

Woolworths will continue to support EFTPOS as a payments system for so long as it remains a low cost and reliable means of making card payments.

Woolworths agrees that an EFTPOS Scheme should improve the future prospects of EFTPOS as a commercial proposition. However, Woolworths warns against any significant changes to the cost structure of EFTPOS resulting from the development of an EFTPOS Scheme. Specifically, the cost of running the EFTPOS Scheme should be minimised, since this cost will be shared across all EFTPOS transactions without any improvement in functionality for existing card present transactions. Furthermore, any new product offerings such as card not present and international payments must not be subsidised by existing card present transactions.

3.3 Cashouts

For so long as credit and/or debit card interchange fees exist at a non-zero level and continue to be regulated by the RBA, cashout interchange fees should be exempted from regulation. Retailers offer cashouts as a basic banking service to consumers on behalf of the consumer’s financial institution. Retailers should be compensated by financial institutions for operating this service, and if compensation ceases individual retailers may choose to discontinue this service.

Woolworths has ATMs located within many of its stores. If Woolworths fails to receive compensation for providing cashout transactions, it will look to migrate cash withdrawals

⁶ P.23, *Reform of Australia’s Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

⁷ P.23, *Reform of Australia’s Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

made at its stores from the point of sale to its ATMs. This strategy will become even more appealing once ATM direct charging is introduced. Woolworths would also consider whether it should continue to offer cashouts. Should the availability of point of sale cashouts decline, this would reduce the level of competition in the market for cash withdrawals.

4 Review of the Honour All Cards Rule

Woolworths encourages any initiatives that prevent card schemes from applying an HACR. An HACR deprives merchants of their right to choose which payment instruments they will accept from their customers, based on the commercial terms of each instrument. As a result, merchants are unable to control their costs of payments acceptance. And worse still, a merchant's ability to negotiate an improved merchant service fee is undermined.

Woolworths currently refuses to accept all prepaid and gift cards except for its own Wish and Essentials cards. The RBA has now clarified that the use of an HACR to enforce acceptance of prepaid and gift cards is inappropriate. Woolworths had requested this clarification from the RBA because Woolworths was placed under pressure to accept prepaid and gift cards. This pressure was applied by other participants in the cards market who informed Woolworths that it must accept prepaid and gift cards because this product category was not explicitly identified in the RBA's HACR Standard.

Woolworths agrees with the RBA's guidance that interchange rates should not penalise merchants who choose not to accept all of a scheme's products. Such interchange rates achieve the same outcome for card schemes as an HACR.

Woolworths also supports the RBA's proposal to further relax the HACR to allow merchants to make independent acceptance decisions about card categories attracting separate interchange rates. As a matter of principle, a merchant should be allowed to refuse acceptance of any card category if it considers the cost of accepting those cards to be too high. The RBA has suggested that under self regulation merchants should be allowed to make independent acceptance decisions for each category of cards for which a separate interchange fee applies. This relaxation of the HACR should be made in any event, regardless of the status of self regulation, since it lifts an anti-competitive restriction currently placed upon merchants.

5 Transparency of Fees

Woolworths considers the RBA's Standard requiring card schemes to publish their interchange schedules to have been a key factor in increasing competition amongst acquirers. Merchant service fees for Scheme card transactions comprise an interchange fee, a Scheme fee and a processing fee that incorporates the acquirer's margin. As a result of the transparency provided by the RBA's Standard, merchants can now approximate how much of their merchant service fee is comprised by interchange. Accordingly, merchants have a better idea of the magnitude of their processing fee and are better placed to negotiate a reduction in this component.

5.1 Scheme Fees

Merchants will have improved transparency over the make up of their merchant service fees once average Scheme fees are published. Such transparency will allow merchants to better approximate the magnitude of their processing fee and thereby improve the prospects of merchants negotiating a reduction in this component.

Woolworths, however, recommends that the RBA advocate complete transparency of Scheme fees. Since acquiring Scheme fees are fully passed on to merchants by acquirers, merchants deserve to know the amount of Scheme fees they are paying. Publication of average Scheme fees would be an improvement on the current situation, but would still leave merchants unaware of how much they are paying in Scheme fees.

Public disclosure of Scheme fees will create greater awareness of these fees, and may introduce some accountability for the card Schemes in setting these fees. However, competition between the card Schemes over Scheme fees will not exist until merchants and/or acquirers have a choice of networks for processing all Scheme transactions.

Publication of Scheme fees will not prevent Scheme fees from being raised to compensate issuers for any reduction in interchange fees. However, it will make any such efforts more visible.

5.2 'On-Us' Scheme Fees

Woolworths has interchange links with selected major Australian card issuers. For a transaction made at a Woolworths store involving a Scheme card issued by one of Woolworths' interchange partners, Woolworths routes the transaction directly to the interchange partner without using the Scheme's network. Consequently Woolworths pays 'on-us' acquiring Scheme fees for these particular transactions.

Even though Woolworths is paying a reduced 'on-us' Scheme fee as a result of sending own Scheme card transactions directly to the issuer, Woolworths does not know how much it is saving on Scheme fees as a result. Since acquiring Scheme fees are passed on to merchants, all merchants should be given the opportunity to calculate the savings in Scheme fees available by implementing a direct to issuer model. The RBA's proposal of publicly reported 'on-us' Scheme fees will help address this situation.

5.3 Interchange Fees

Public disclosure of each card scheme's weighted average interchange fee will improve transparency, enabling the effects of changes to interchange schedules and product mixes to be better understood. At present it is difficult to quantify the impact of any change to a scheme's interchange schedule since no information is available on the transaction volumes for each interchange category. Furthermore, product mixes change over time and this effect can not be quantified.

Woolworths supports the RBA's proposal to publicise each card scheme's weighted average interchange fee.

6 Network Choice

The RBA has expressed a willingness to pursue industry self regulation in an attempt to promote competition within the Australian market for card payments. However, Australia cannot have a truly competitive market for card payments without effective competition between card scheme networks. At present very little competition exists between card schemes, and self regulation is unlikely to improve this.

Effective competition between card schemes could be stimulated by providing acquirers and/or merchants with a choice of networks for processing card transactions. The RBA has undertaken an initial assessment of the concept of providing a choice of network for card processing. It identified practical difficulties in the technical implementation of this concept. Given that the Payments System Board (PSB) has recognised that network choice could “have a profound effect on competition”⁸, Woolworths encourages the RBA to pursue a workable solution to enable network choice.

Network choice should be viewed as a necessary prerequisite for the PSB to consider self regulation given the PSB’s assessment that “if interchange regulation is to be wound back, all feasible steps need to be taken to enhance the competitive environment”⁹.

Yours sincerely,



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⁸ P.29, *Reform of Australia’s Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.

⁹ P.33, *Reform of Australia’s Payments System: Preliminary Conclusions of the 2007/08 Review*, April 2008.