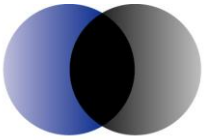
Submission to the Reserve Bank of Australia

2007/08 Review of the Reform of Australia's Payments System

Submission prepared on behalf of American Express Australia Limited

August 2007



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1 Introduction

This submission to the 2007/08 review of the reform of Australia's payments system conducted by the Reserve Bank of Australia (RBA) has been commissioned by American Express Australia Limited. However, all views and opinions expressed in this submission are those of ACIL Tasman. The submission focuses on the following:

- the effect of the interchange fee reforms on financial institutions (interchange fee reforms)
- the characteristics of payment systems that have given rise to public policy concerns, particularly over interchange fees (characteristics of payment systems)
- resource costs and substitution issues for payment cards (resource costs and substitution issues)
- access arrangements and scheme rules in payment systems (access arrangements and scheme rules)
- regulation of other payment systems
- self-regulation.

2 Interchange Fee Reforms

Paragraph 108(i) of the RBA's issues paper[1] on the reform of Australia's payments system suggested that parties might address:

> the effect of the reforms on the net revenue of financial institutions. (In many analyses of interchange fees it is assumed that these fees are a way of redistributing revenue from acquiring banks to issuing banks in a way that affects the prices facing cardholders and merchants, but not necessarily the net revenue of banks.)

ACIL Tasman offers the following observations in regard to the impact on bank revenue from changes in credit card interchange fees. The effect of the interchange fee reforms on bank income has been positive in nominal terms and negative in real terms. Reductions in credit card interchange fees imposed through regulations, which have been passed onto merchants through reductions in merchant service fees, have led to a reduction in bank income received from merchant service fees in both real and nominal terms between 2003 and 2006. However, since 2003 the level of bank income received from credit card fees levied on households has increased.[2]

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[1] Reserve Bank of Australia (2007) *Reform of Australia's Payments System: Issues for the 2007/08 Review*. May 2007, Sydney.

[2] Does not include interest income.

In nominal terms between 2003 and 2006 bank income from merchant service fees has fallen by $345 million from $1,826 million in 2003 to $1,481 million in 2006. While over the same period, bank income from household credit card fees has increased by $429 million, from $589 million in 2003 to $1,018 million in 2006. Figures are provided in Table 1 below.

Table 1 **Bank Income from Merchant Service Fees and Household Credit Card Fees in Nominal Terms**

Year	Bank Income from Merchant Service Fees ($ million)	Bank Income from Credit Card Fees on Households ($ million)	Total Income ($ million)
2002	$1,622	$425	$2,047
2003	$1,826	$589	$2,415
2004	$1,516	$761	$2,277
2005	$1,468	$899	$2,367
2006	$1,481	$1,018	$2,499

Data source: Reserve Bank of Australia (2007) Banking Fees in Australia. *Reserve Bank Bulletin May 2007,* Sydney, 59-62; Reserve Bank of Australia (2006) Banking Fees in Australia. *Reserve Bank Bulletin May 2006,* Sydney, 60-64.

In real terms between 2003 and 2006 bank income from merchant service fees and credit card fees on households has fallen by around $129 million (in 2006 dollars after deflating by the consumer price index). While bank income from merchant service fees has fallen by $506 million in real terms between 2003 and 2006, bank income from credit card fees on households has increased by $377 million in real terms over the same period. In real terms, the banks have made up around 75 per cent of the income reduction in merchant service fees through increased receipts from credit cards fees on households. Figures are provided in Table 2 below.

Table 2 **Bank Income from Merchant Service Fees and Household Credit Card Fees in Real Terms (2006 Dollars)**

Year	Bank Income from Merchant Service Fees ($ million)	Bank Income from Credit Card Fees on Households ($ million)	Total Income ($ million)
2002	$1,813	$475	$2,288
2003	$1,987	$641	$2,628
2004	$1,612	$809	$2,421
2005	$1,519	$930	$2,449
2006	$1,481	$1,018	$2,499

Data source: Reserve Bank of Australia (2007) Banking Fees in Australia. *Reserve Bank Bulletin May 2007*, Sydney, 59-62; Australian Bureau of Statistics (2007) *Consumer Price Index, Australia.* June Quarter 2007, Catalogue No. 6401.0.

In response to the payments system reforms announced by the RBA in August 2002, all credit card issuers increased their user fees. The ANZ Bank increased

credit card fees by an average of 48 per cent from December 2002.[3] The Commonwealth Bank announced fee increases effective from January 2003.[4] St George increased its base MasterCard credit card fee by 51 per cent.[5] The ANZ Bank commented in its 2003 annual report that it reshaped its "product set across the Australian Cards Issuing portfolio to address the impact of the Reserve Bank interchange reforms".[6]

In addition, credit card issuers also applied a new range of fees and charges from January 2003 including increases in ATM fees, overseas cash advances, foreign exchange conversion fees and over-the-counter cash access fees. Between 2003 and 2006 bank income from fees on household deposit accounts in nominal terms has grown on average by 7.2 per cent per annum and rose by 8.9 per cent in 2006, from $1,309 million in 2003 to $1615 million in 2006.[7]

While bank income has declined from merchant service fees since the reforms to credit card interchange fees, this has been more than compensated for in increased bank income generated from credit card fees and other fees and charges levied on households.

3 Characteristics of Payment Systems

Paragraph 116 of the RBA's issues paper suggested:

> Submissions on this issue may wish to comment on any lessons from recent experience and insights from theoretical research about the influence of the market structure, conduct and performance of payment systems for the efficiency of the payments system as a whole.

In this section of the submission ACIL Tasman wishes to draw to the RBA's attention:

- the long-established theory in the field of industrial organisation
- recent theoretical developments in regard to two-sided markets and their possible application to credit and charge cards in Australia.

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[3] Halverson, G. (2007) Regulation: Australian Interchange – three years on. *Cards International*, London, 20 February.

[4] *ibid.*

[5] *ibid.*

[6] Australian and New Zealand Banking Group Limited (2003) *2003 ANZ Annual Report*. Melbourne.

[7] Reserve Bank of Australia (2007) Banking Fees in Australia. *Reserve Bank Bulletin* May 2007, Sydney, 59-62.

ACIL Tasman submits that because of aspects of these two theories the concerns previously expressed publicly by the RBA on the pricing practices of American Express may be misplaced.

Assuming that the provision of American Express cards occurs within a traditional one-sided market[8], the RBA's analysis arguably fails to take into consideration product differentiation and the position strongly advocated by American Express that it offers its cardholders a superior good compared to other products available in terms of a card payment option.[9] The company claims that the superior product offering provided by American Express has attracted a high spending cardholding customer base. Such a base of high spending customers has been described as marquee buyers by prominent industrial organisation economists Rochet and Tirole.[10] Without a cardholding customer base that provides a value proposition to merchants, it could be argued that American Express would not attract any merchants to accept its cards.

It would appear that public statements and reflections regarding American Express pricing policies suggest that the RBA considers that payment cards should be a commodified product where competition should be reminiscent of perfect competition. For example, the RBA Bulletin from July 2004 commented in regard to the merchant service fees of American Express and Diners Club that:

> a further decline in these merchant service fees should be expected. The competitive forces that are important in delivering this outcome are likely to work more quickly the more prepared are merchants to decline acceptance of these cards based on their high cost or to charge customers directly for this cost.[11]

According to then RBA Assistant Governor (Financial System) Dr Phillip Lowe:

> We expect that competition will lead to a further decline in American Express's average merchant service fee, and in time, this will be reflected in the structure of the products that are offered. If this was not to happen, and the beneficial effects of the

[8] The distinction between one-sided and two-sided markets is considered further in section 2.2 below.

[9] A superior good is commonly defined as one which makes up a larger proportion of consumption for a consumer as income rises.

[10] J. C. Rochet and Tirole, J. (2003) Platform Competition in Two-Sided Markets. *Journal of the European Economic Association* 1, 990-1029, p. 1014.

[11] Reserve Bank of Australia (2004) Merchant Service Fees for Credit Cards. *Reserve Bank of Australia Bulletin*, 10-13, p. 13.

> reforms were to be eroded materially, we would need to look again at whether other options were in the public interest.[12]

There is considerable evidence to suggest that a commodified market characterised by perfect competition is not an appropriate analytical framework from which to assess competition within payment card markets. According to prominent US economist Harold Demsetz[13], perfect competition is a poor standard by which to make real world competition (antitrust) assessments:

> The perfect competition model used by economists to set forth an idealised concept of competition is not of much use in guiding us to the preferred mixture of competitive forms that is a meaningful goal for antitrust…
>
> It offers no productive role for *reputational competition* because it assumes full knowledge of prices and goods, and it ignores *competition to change demands* by taking tastes as given and fully known. Its informational and homogeneity assumptions leave no room for firms to compete by being different from other firms. Within its narrow confines, the model examines the consequences of only one type of competition, price competition between known, identical goods produced with full awareness of all technologies. This is an important conceptual form of competition, and when focusing on it alone we may speak sensibly about maximising the intensity of competition. Yet, this narrowness makes the model a poor source of standards for antitrust policy.[14] (Italicised words are as they appeared originally)

3.1 Product Differentiation

Product differentiation can be highly beneficial to consumers through providing product innovation and quality improvements. The economic theory in relation to product differentiation was originally developed by Harold Hotelling and Edward Chamberlin who were leading economists in the field of industrial organisation during the late 1920s and 1930s. Economic theory on product differentiation goes back to 1929 when it was first recognised as a competitive variable by Hotelling[15] and is still widely used in industrial organisation literature to this day. In order to attract a customer base to a new product, Hotelling believed that it would be advantageous to make a slight change to an existing product "which will seem an improvement to as many buyers as possible".[16]

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[12] Lowe, P. (2006) The Evolution and Regulation of the Payments System. Address by Phillip Lowe, Assistant Governor (Financial System) RBA to Payments System Conference, Melbourne Business School, Melbourne 14 March 2006.

[13] Harold Demsetz is a professor emeritus of economics at the University of California at Los Angeles.

[14] Demsetz, H. (1992) How Many Cheers for Antitrust's 100 Years? *Economic Inquiry* 30, 207-216, p. 209.

[15] Hotelling, H. (1929) Stability in Competition. *The Economic Journal* 39, 41-57.

[16] *ibid.*, p. 54.

The term product differentiation was first used by Chamberlin in the 1930s.[17] Chamberlin developed his theory of monopolistic competition asserting that product markets often displayed the characteristics of both monopoly and competition. Monopoly was defined as giving a producer control over the supply of a product, and therefore control over the price as well. On the other hand, the level of control which a producer could exercise over a product price would be completely eliminated "when all producers are producing the identical good and selling it in the identical market".[18] If the product of one producer differed slightly from that of other producers, then Chamberlin contended that this would be sufficient to give that producer some degree of control over the price charged for their product.

The public commentary by the RBA suggests that the American Express pricing to merchants is somehow higher than desirable. However, the company has argued that its pricing reflects its ability to differentiate itself from its competitors by virtue of its superior product offering to its cardholding customers. It could also be argued that the negative public commentary by the RBA on merchant service pricing by American Express amounts to an indirect attack on product differentiation, which is a common attribute of activity in many markets.

It is therefore important to assess what economic theory has to say in regard to the welfare implication of product differentiation. Economic theory is generally neutral in regard to the welfare implications of product differentiation. According to prominent US antitrust jurist Jonathan B. Baker[19]:

> Differentiation itself is not unambiguously good or bad. Buyers typically benefit from the availability of a wide variety of product offerings to serve their differing preferences. Yet differentiation can also facilitate the exercise of market power.[20]

Hence, the welfare implications of product differentiation are such that it would appear to raise welfare concerns only in the event that it facilitates the exercise of market power. It is argued later in this submission that American Express does not exercise substantial market power in any market in which it participates within Australia.

Given that credit and charge cards compete in a differentiated products market, it is not unusual for there to be price disparities observed between the

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[17] Chamberlin, E. H. (1948) *The Theory of Monopolistic Competition*. Sixth Edition, Harvard University Press, Cambridge, Massachusetts.

[18] *ibid*., p. 7.

[19] Professor of Law at Washington College of Law, American University, and former Director of the Bureau of Economics with the Federal Trade Commission.

[20] Baker, J. B. (1997) Product differentiation through space and time: some antitrust issues. *Antitrust Bulletin* 42, 177-196, p. 179.

different and competing products. This is especially the case in regard to a card which provides superior product offerings, which American Express maintains that it offers its customers.

On this basis, ACIL Tasman suggests that it is too simplistic to contend that price differentials between competing products within a differentiated goods market should remain constant or fixed. The existence of any price differential is the culmination of the interactions of numerous market participants. Attempting to second-guess the deliberations of the market (particularly in the absence of any natural monopoly characteristics) could have severe and negative social welfare and resource allocation consequences.

3.2 Two-Sided Markets

The joint study by the ACCC and the RBA found that payment cardholders were effectively being subsidised by card issuers to use credit cards as a payments instrument at the expense of lower cost payment instruments such as direct debit and debit cards.[21] The joint study concluded that Australia had a higher cost retail payments system than was necessary, and that much of this higher cost was borne by consumers who did not use credit cards.[22]

In response to the joint study, the RBA released its consultation document in December 2001 in which it contended that:

> The pricing of credit card services is sending consumers a quite misleading signal about the cost to the community of different payment instruments, while barriers to entry are quarantining the credit card schemes from the competitive pressures that nonfinancial institutions of substance could bring to bear. Overall, the community is paying a higher cost for its retail payments system than is necessary.[23]

In August 2002 the RBA announced the regulation of credit card interchange fees with the adoption of an objective, transparent and cost-based benchmark to be used as a basis for determining interchange fees.[24]

However, developments in economic theory in regard to two-sided markets call into serious question the economic rationale behind the RBA's decision to regulate through the imposition of a cost-based benchmark methodology to set credit card interchange fees. Rochet and Tirole contend that the rationale of

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[21] Reserve Bank of Australia and Australian Competition and Consumer Commission (2000) *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*. October, p. v.

[22] *ibid.*

[23] Reserve Bank of Australia (2001*) Reform of Credit Card Schemes in Australia I: A Consultation Document*. December, p. vi.

[24] Reserve Bank of Australia (2002) Reform of Credit Card Schemes in Australia. Media Release, 227 August.

imposing a cost-based benchmark methodology to set credit card interchange fees is based on the incorrect notion of a vertically organised market:

> The idea of a cost-based regulation of [interchange fees] erroneously relies on a model of a vertically organised market, in which an "upstream unit" supplies an intermediate input to a "downstream unit", which then serves the final consumer. The analogy is based on the idea that the issuer (the upstream unit) supplies a service (cardholder servicing, and transaction guarantee) to the acquirer (the downstream unit), who then handles the merchant.[25]

Rochet and Tirole contend the problem with the proposition that there is a vertically organised market is that it ignores there are parties servicing two interdependent but separate customer groups. On one side there are card issuers who service cardholders and on the other side there are acquirers who service the merchants. On this basis payment card networks are two-sided.[26]

Within two-sided markets there is a pressing need to get both sides on board, which in the case of payment card networks requires balancing the demands of cardholders and merchants.[27] There are numerous examples of two-sided markets including newspapers and commercial television networks that need to attract both advertisers and readers/viewers as well as videogame platforms that need to attract users in order to convince game developers to design games for the platform. The afternoon weekly newspaper *MX* distributed free of charge in the Melbourne, Sydney and Brisbane central business districts is an example of a two-sided market where the cost of providing the product is financed entirely through advertising revenue with readers receiving the product for free. Similarly, software programs such as Adobe and RealPlayer are distributed free of charge to users and charge the other side of the market in writers and content providers.

According to Evans, an academic and consultant who has contributed extensively to the literature on the economics of payment cards, the providers of services within two-sided markets coordinate the demands of distinct customers who need each other in some way.[28] Within a payment cards market, there are externalities created when cardholders and merchant become connected or coordinated.[29] On the one hand, the cardholder benefits when a merchant accepts their card for payment. On the other hand, a merchant receives a benefit when a cardholder has a form of payment that they accept.

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[25] Rochet, J. C. and Tirole, J. (2003) An Economic Analysis of the Determinations of Interchange Fees in Payment Card Systems. *Review of Network Economics* 2, 69-79, p. 69.

[26] *ibid.*, p. 70

[27] *ibid.*, p. 70

[28] Evans, D. S. (2003) The Antitrust Economics of Multi-Sided Platform Markets. *Yale Journal of Regulation* 20, 325-381, p. 325.

[29] *ibid.*, p. 332.

Evans describes these externalities as indirect network effects which occur when the value obtained by one kind of customer increases when there is an increase in the number of the other type of customer.[30]

The existence of indirect network externalities creates opportunities for entrepreneurs to create a platform that brings two customer groups together within a single network.[31] Within the specific case of a payment card platform, Evans has described such entrepreneurs as demand coordinators who enable cardholders and merchants to consummate transactions using a payment card.[32] Within a payment card platform, demand coordinators need to provide distinct services to cardholders and merchants designed to stimulate demand for the card.[33]

Economic theory in regard to two-sided markets has profound implications for pricing in relation to both markets being serviced. As we understand it, the RBA's entire approach towards payment card reforms has been predicated on the basis that merchants have not been able to send an appropriate price signal to cardholders to either encourage or discourage them in the use of their card, thereby resulting in a cross-subsidy from merchants (which in turn is funded by all their customers) to cardholders, thus leading to a misallocation of resources through the overuse of more expensive payment options in the form of credit cards and charge cards. However, Rochet and Tirole have suggested that this reasoning ignores the fact that merchants accept payment cards not solely for the convenience benefits they derive (eg fraud protection, accounting facilities etc.), but also because card acceptance makes their store more attractive to consumers.[34] According to Rochet and Tirole, merchants realise that card acceptance is part of their quality of service package and accordingly internalise, at least in part, the cardholders' net benefit from being able to use their card.[35]

In order to "keep everyone on board", pricing within a two-sided market will be determined through balancing the demands of the different customer groups. Businesses within two-sided markets may choose to price discriminate by charging one group of customers a lower price and charging another group a higher price. Evans observes that unless a network platform can attract

[30] *ibid.*, p. 332.

[31] *ibid.*, p. 333.

[32] *ibid.*, p. 335.

[33] *ibid.*, p. 335.

[34] Rochet, J. C. and Tirole, J. (2006) Externalities and Regulation in Card Payment Systems. *Review of Network Economics* 5, 1-14, p. 3.

[35] *ibid.*, p. 3.

enough of the former group, then it will not be able to obtain any sales at all.[36] According to Evans, the side with much lower indirect network externalities is more likely to receive "lower prices" compared with the side with greater indirect network externalities.[37] Rochet and Tirole observe that in the case of a two-sided market, such as payment networks, it is entirely possible that one side of the market is left entirely free of charge.[38]

A critical finding from the economic literature on two-sided markets is that optimal pricing strategies, whether measured socially or privately, do not follow marginal cost on either side of the market.[39] An important implication of this finding is that the standard price-marginal cost relationships based on only one side of the market has no economic relevance and provides no guidance to businesses in regard to profit-maximisation (where marginal cost is equated to marginal revenue in the case of a firm exercising market power) nor regulators to social-welfare-maximising prices (where marginal cost is equated to price).[40] The determination of profit maximising and social-welfare-maximising prices needs consideration of marginal costs on all sides jointly along with demand characteristics.[41] According to Evans, this creates a challenging optimisation problem for a platform provider and an onerous information problem for a regulator.[42]

This raises the issue of whether the relative pricing adopted by multi-sided firms, which has been characterised in some quarters as one side seemingly subsidising the other side, is socially inefficient. Because the normal rules of price optimisation don't apply in relation to two-sided markets, Evans concludes that there is no reason to believe that charging one side of the market relatively low prices and the other side relatively high prices is inefficient in and of itself.[43]

Consideration of payment cards as a two-sided market raises doubt as to whether there is any cross-subsidy flowing from merchants and their customers to cardholders in regard to credit and charge card usage. Wright rejects the idea that there is any sort of cross-subsidy arguing:

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[36] Evans, D. S. , *op cit*., p. 338.

[37] *ibid*., p. 343.

[38] Rochet, J. C. and Tirole, J. (2003) An Economic Analysis of the Determinations of Interchange Fees in Payment Card Systems. *Review of Network Economics* 2, 69-79, p. 73.

[39] Evans, D. S., *op cit*., p. 328.

[40] *ibid*., p. 345.

[41] *ibid*., p. 345.

[42] *ibid*., p. 345.

[43] *ibid*., p. 355.

> consider the case of an American Express charge card, which merchants pay for through merchant fees, and which consumers pay nothing to use. Suppose some consumers use this card, while other consumers use cash (which is assumed to be costless). Suppose, further, that the price of goods sold by merchants is increased to cover the merchant fee. Even under these somewhat extreme assumptions, users of American Express charge cards do not enjoy a cross-subsidy from cash-users. If they did, then a merchant would be better off if the consumers who pay by American Express charge cards were banned from using the card for purchases at the merchant's store. One can safely assume this is not the case, for if it were, it would contradict the fact the merchant voluntary chooses to accept cards, presumably to increase overall profits.[44]

Furthermore, Evans has argued that it is extremely difficult to apportion costs to either side of a market within a two-sided market context. According to Evans:

> much of the costs of payment card transactions is either joint, in the sense that the costs arise when a transaction occurs (the cost of authorisation and settlement), or the allocation of costs to one side or other economically arbitrary (the cost of funds, charge-offs, fraud, and other risks).[45]

and that

> It is well recognised by economists that in multi-product businesses the allocation of joint costs to a particular product is arbitrary and that there is no economic justification behind any proposed formula for doing so.[46]

Due to the superior product offering arguably provided to its cardholders, American Express has been able to charge higher prices to merchants. Through the two-sided market analytical framework, American Express could be providing a higher indirect network externality to merchants otherwise they would refuse to accept American Express cards. For example, Evans has observed:

> American Express has been able to charge a relatively high price to merchants as compared to other card brands, because merchants viewed the American Express business clientele as extremely attractive.[47]

We suggest that theoretical advances on two-sided markets provide a basis for the RBA to reconsider its analytical framework in regard to payment card markets. We also suggest that this reconsideration may well persuade the RBA

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[44] Wright, J. (2004) One-sided Logic in Two-sided Markets. *Review of Network Economics* 3, 44-64, pp. 59-60.

[45] Evans, D. S., *op cit.*, p. 341.

[46] *ibid.*, p. 345.

[47] *ibid* ., p 353.

that it need not undertake further regulatory intervention in relation to card platforms.

4 Resource Costs and Substitution Issues

Paragraph 117 of the RBA issues paper comments:

> the Bank's rationale for regulating interchange fees has rested heavily on the ideas that these fees are not subject to the normal forces of competition and that the then configuration of interchange fees was distorting payment patterns.
>
> Submissions may therefore wish to comment on whether, given the current structure of the main payment systems, competition between, and within, these systems is likely to deliver a configuration of interchange fees that promotes the overall efficiency of the payments system.
>
> In addressing this issue, submissions might wish to offer evidence on the relative resource costs of different payment methods and the potential for substitution between payment methods.

4.1 Implications of Two-Sided Markets for Credit Card Interchange Fees

According to Wright, the efficiency implications of cost-based pricing in a network setting where cross-user externalities are important can be undesirable.[48] Wright contends that adopting a price structure that reflects the costs of serving each type of user (adopting a user-pays approach) would only be efficient by chance.[49]

Hunt, of the US Federal Reserve Bank, concludes on the basis of available literature that an interchange fee based purely on costs, ignoring the effect of changes in prices on consumers' and merchants' demand for payments services, is generally not socially optimal.[50] According to Emch and Thompson:

> the conventional wisdom that pricing close to marginal cost is efficient does not hold when each side of a two-sided market is examined in isolation. It may well be that efficient pricing dictates a price above, or below, marginal cost on a particular side of the market.[51]

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[48] Wright, J. (2004) One-sided Logic in Two-sided Markets. *Review of Network Economics* 3, 44-64, p. 53.

[49] *ibid.*, p. 54.

[50] Hunt, R. M. (2003) An Introduction to the Economics of Payment Card Networks. *Review of Network Economics* 2, 80-96, p. 88.

[51] Emch, E. and Thompson, T. S. (2006) Market Definition and Market Power in Payment Card Networks. *Review of Network Economics* 5, 45-60, p. 47.

4.2 Costs of Different Payment Methods

In regard to the relative resource costs of using different payment methods, an apparent deficiency in most previous studies is that no attempt has been made to estimate both the costs and benefits accruing to all parties from using a particular payment instrument. According to Chakravorti (a senior economist in the economic research department at the US Federal Reserve Bank of Chicago):

> it is surprising that few authors consider the costs and benefits of credit when studying credit card networks.[52]

When total costs and benefits are assessed, an entirely different picture emerges of the welfare implications of using payment options that have previously been branded as high cost.

ACIL Tasman suggests that, prima facie, any approach that considers only the costs and not the benefits of particular payment methods for the multiple parties concerned is flawed.

4.2.1 Australian Studies of Resource Costs

The 1997 financial system inquiry report (Wallis Report) found that "comprehensive data on the costs and efficiency of the payments system are not publicly available in Australia".[53] Based on data provided to the inquiry, the Wallis Report found that "the costs associated with processing paper and in-branch transactions are high relative to electronic delivery mechanisms".[54]

The 2000 joint study by the RBA and the Australian Competition and Consumer Commission (ACCC) on credit and debit card interchange fees produced estimates of costs incurred by banks for processing various payment options.[55] A summary of this information is produced in Table 3 below.

Table 3 **Weighted Average of Costs Incurred by Banks per Transaction for ATMs, Credit Cards and Debit Cards ($100 transaction)**

	ATM Withdrawal ($)	Debit Card ($)	Credit Card ($)
Total Cost	0.49	0.41	2.36

Data source: Reserve Bank of Australia and Australian Competition and Consumer Commission.

Note: Costs incurred for credit and debit cards include both acquiring and issuing costs.

[52] Chakravorti, S. (2003) Theory off Credit Card Networks: A Survey of the Literature. *Review of Network Economics* 2, 50-68, p. 64.

[53] Wallis, S. (Chairman) (1997) *Financial System Inquiry Final Report*. Australian Government Publishing Service, Canberra, p. 223.

[54] *ibid*., p. 226.

[55] Reserve Bank of Australia and Australian Competition and Consumer Commission (2000) *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*.

According to the RBA the cost of using and providing cash has not been intensively studied in Australia although it has arrived at its own estimates comparing the estimated resource costs of using cash, EFTPOS and credit cards for a $58 transaction.[56] This information is reproduced in Table 4 below:

Table 4 **Estimated Resource Costs of Payments (per $58 transaction)**

	Cash	EFTPOS	Credit Card
Issuer	0.17 – 0.40	0.15	≤ 1.47
Acquirer	0.35 – 0.60	0.26	0.43
Consumer	0	0	0
Merchant	0.12	≤ 0.17	≤ 0.17
TOTAL	0.64 – 1.12	≤ 0.58	≤ 2.07

Data source: Reserve Bank of Australia

The RBA has cautioned that its calculations should be considered as indicative rather than definitive. There are arguably hidden transaction costs incurred by the consumer and probably the merchant and differences between them for all three payments methods that have not been factored into the above estimates.

The Australian Retailers Association has estimated the cost incurred by retailers of accepting various payment instruments as well as the cost as a percentage of the sales attributed to the various payment instruments.[57] A summary of the results is presented below in Table 5.

Table 5 **Estimated Cost of Various Payment Instruments and Transaction Cost as a Percentage of Sales**

Payment Instrument	Cost of Payment Instrument ($)	Transaction Cost as a Percentage of Sales (%)
Cash	0.12	0.7
Cheque (Online Authority)	0.49	1.4
Bank Issued Credit Cards	1.04	1.9
Charge Cards	2.01	2.9
Debit Cards	0.17	0.3

Data source: Australian Retailers Association

A study by the Centre for International Economics (CIE) and Edgar, Dunn & Company (EDC) prepared for the Commonwealth Government Department of Communications, Information Technology and the Arts has opined in regard to estimating the cost of various payment options that:

[56] Reserve Bank of Australia (2003) *Submission to the Australian Competition Tribunal re: Application for Review of the Determination of the Australian Competition and Consumer Commission Authorisation A30224 and A30225 in Relation to the Collective Setting of EFTPOS Interchange Fees*. Sydney.

[57] Australian Retailers Association (2001) *Submission to the Reserve Bank of Australia: Credit Card Schemes in Australia.*

> when reviewing the existing literature in Australia it is apparent that there is an absence of a transparent framework against which to identify costs, benchmark performance and efficiency. This appears to be a fundamental constraint to making informed decisions about the future of electronic payments systems or in assessing the effectiveness of current approaches in Australia.[58]

CIE and EDC have made new estimates of the economy-wide cost of different payment types. However, they warn that these estimates should be treated with "caution" and are "merely illustrative of the likely magnitude of the resource cost to the economy of the major payment categories".[59]

The CIE and EDC estimates provide two estimates of cost. The cost per transaction is the estimate of the total cost divided by the estimated number of transactions using the particular payment method. The cost per dollar-value transferred is the estimated cost allowing for the value of transaction (which takes into consideration that while there may be many cash transactions, these are often for small amounts). A summary of the results is presented below in Table 6.

Table 6 **Economy-wide estimates of costs for different payment types**

Payment Method	Approximate cost per transaction ($)	Indicative cost per $ value transferred (%)
Direct credits	0.45 – 0.50	0.01 – 0.02
Direct debits	0.40 – 0.55	0.01 – 0.02
Cheques	1.60 – 1.75	0.05 – 0.08
Debit cards	0.60 – 0.65	1.00 – 1.10
Charge cards	5.65 – 6.00	3.00 – 3.20
Credit cards	2.65 – 2.75	2.00 – 2.10
Cash payment	0.70 – 0.80	3.60 – 4.00

Data source: Centre for International Economics and Edgar, Dunn & Company.

CIE and EDC warn that the costs of different payment instruments should not be compared without also taking into consideration the different capabilities and functions offered by each product and the benefits that these differences provide to users of that product.

Major findings from the CIE and EDC study include:

- Broadly, electronic payments are significantly cheaper than the non-electronic alternatives.

[58] Centre for International Economics and Edgar, Dunn & Company (2006) *Exploration of future electronic markets*. Report Prepared for the Australian Government Department of Communications, Information Technology and the Arts and Industry Sponsors, p. 41.

[59] *ibid.*, p. 43.

- Cash is the most expensive means of payment when measured as a per cent of the transaction type.

Based on Australian studies, it would appear that credit cards are a relatively expensive payment option. However, it also needs to borne in mind that credit cards provide a range of benefits through the services they provide to consumers – convenience, accounting, avoidance of the need to carry cash and the associated risk, and minimisation of fraud.

4.2.2 International Studies of Resource Costs

A study by Norges Bank, the central bank of Norway, undertook a survey of the cost of providing various services within the Norwegian payments system by banks during 2001.[60] The survey was based on a method known as activity-based costing analysis. While credit card and charge card schemes were not part of the survey, the study found that "[t]raditional, paper-based services are relatively more expensive to produce than modern, electronic services". One particular finding was that the cost of processing a cheque transaction was nine times more expensive than an EFTPOS transaction.

In a recent study, Garcia-Swartz, Hahn and Layne-Farrar have been critical of existing empirical literature that estimates the costs of using particular payment instruments because they typically disregard the benefits and do not always consider all parties to a transaction.[61] Instead, they maintain that both social costs and social benefits need to be considered when comparing payment instruments for policy decisions.[62] Key findings from the Garcia-Swartz et al. study are:

- At smaller transaction sizes, the net social marginal cost of all payment instruments – paper and electronic alike – are remarkably similar with no one instrument standing out as more socially efficient.[63]
- For larger transaction sizes, significant differences emerge. For grocery store transactions, electronic payments are considerably less costly on net terms for society than paper transactions. For larger transactions at electronic stores, credit cards (and charge cards) with a large proportion of reward cardholders have the lowest net social marginal cost.[64]

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[60] Gresvik, O. and Owre, G. (2003) *Costs and Incomes in the Norwegian Payment System 2001: An Application of the Activity Based Costing framework*. Norges Bank Working Paper ANO 2003/8, Oslo.

[61] Garcia-Swartz, D. D., Hahn, R. W. and Layne-Farrarr, A. (2006) The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics. *Review of Network Economics* 5, 175-198, p. 195.

[62] *ibid.*

[63] *ibid.*

[64] *ibid.*

- While paper methods are the cheapest payment instruments for merchants, it is not the cheapest payment instrument for the economy as a whole. However, what may be cheap for merchants is relatively expensive for other parties to a transaction. In particular, consumers receive considerable benefits from payment cards, which tip their net private costs in favour of that method of payment.[65]

4.3 Potential for Substitution between Payment Options

According to Chakravorti, little research has been done regarding competition between different payment products.[66]

The 2000 joint study by the ACCC and the RBA contended that a customer using a credit card solely as a payment instrument and not a credit facility would find a debit card to be a close substitute.[67] Under these circumstances, the joint study maintained that the choice as to which type of these two cards to use would be heavily influenced by their relative price and other incentives.[68] However, it was also observed that for a cash-constrained consumer, a debit card was unlikely to be viewed as a close substitute for a credit card as it did not offer an automatic credit facility.[69] The joint study opined that increasing credit card usage may have been as a substitute means of payment for cash as well as for other non-cash means of payment such as cheques.[70]

In its 2006 annual report, the RBA's payments system board concluded that debit and credit cards are close substitutes for one another in regard to most face-to-face transactions, particularly given that a credit card in many situations is viewed as a payment card rather than an ongoing source of credit given that most consumers usually pay off their credit card bill each month.[71] One area highlighted by the Payments Board where debit and credit cards are not good substitutes is for payments over the telephone and the internet where the PIN-based EFTPOS debit cards cannot be used.[72]

The deliberation of courts in the United States has led to different conclusions on the extent of substitution between credit cards, charge cards and other

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[65] *ibid.*, p. 196.

[66] Chakravorti, S., *op cit.*, 64.

[67] Reserve Bank of Australia and Australian Competition and Consumer Commission, *op cit.*, p. 28.

[68] *ibid.*, p. 77.

[69] *ibid.*, p. 28.

[70] *ibid.*, p. 78.

[71] Payments System Board (2006) *Annual Report 2006*. Reserve Bank of Australia, Sydney, p. 6.

[72] *ibid.*

payment options. In the matter of the NaBanco case during the 1980s, the court found that credit cards were not the relevant product market, which was in fact far wider and included other payment methods that included cash, cheques and debit cards.[73] However, in a more recent judgement the court explicitly rejected the argument that credit cards were part of a wider market with other payment options such as cash, cheques, debit cards and store cards because these other payment options were not considered by most consumers to be reasonable substitute for general purpose credit or charge cards.[74] On this occasion the court reasoned that while it was literally true that cash and cheques are substitutable for credit cards, they are not so in practice in regard to internet sales transactions.[75]

There are important differences between credit and charge cards on the one hand and debit cards on the other. While a debit cardholder finances any payment directly from their own resources, credit and charge cards offer cardholders a line of credit. Certain credit and charge cards offer cardholders other services such as automatic insurance on purchases as well as reward schemes which are not available to debit cardholders. While there may be a high degree of substitutability between credit and charge cards with debit cards (in addition to other payment options) in regard to settling transactions, it is probably reasonable to conclude that there is not perfect substitution between credit and charge cards with debit cards.

5 Access Arrangements and Scheme Rules

Paragraph 118 of the RBA's issues paper suggests:

> Submissions might also address potential public policy concerns regarding access arrangements and scheme rules in payment systems.

The policy rationale behind the RBA's previous decision to seek the removal of no-surcharge rules from credit and charge card schemes was predicated on concern that consumers who did not use these payment options were being harmed by these restrictions. According to the RBA, this harm was being caused because consumers not using credit and charge cards were paying higher retail prices because other consumers were facing distorted price signals and choosing to use a relatively more expensive payment option as a

[73] *National Bankcard Corp v. VISA USA, Inc.*, 596 F. Supp. 1231 (S.D Fla. 1984).

[74] *U.S. v Visa U.S.A., Inc.*, 163 F. Supp 2d. 335–38 (S.D.N.Y).

[75] *ibid.*

consequence.[76] As referred to previously, Wright has cast doubt on the veracity of this cross-subsidy argument.[77]

ACIL Tasman also notes that it is unlikely that the RBA has managed to eliminate no-surcharge rules altogether. It is understood that the provision of in-store finance products (such as offered by GE Money) contain rules that effectively amount to a no-surcharge rule. If the RBA maintains its previous position on the harm inflicted on consumers by no-surcharge rules and is to be consistent in its previous policy approach, then it needs to ensure that no-surcharge rules are not present in regard to any other payment instrument.

A key policy goal of the RBA in its reforms to the payments system has been to increase competition.[78] However, ACIL Tasman believes that the prohibition on no-surcharge rules could constitute a significant barrier to entry to new credit and charge card providers as well as to the further expansion of less developed credit and charge card providers.

Bain defined barriers to entry in an industry as the advantage that existing sellers enjoyed over potential entrant sellers, that in turn reflected the capacity of existing sellers to raise their price over the competitive level without attracting new entry.[79] Another definition of market power is a structural characteristic of a market that protects the market power of incumbents by making entry unprofitable.[80]

Concerns regarding barriers to entry within payment card markets are predicated on such markets being two-sided and the need to build critical mass on both sides of the market. Within the context of two-sided markets, prohibitions on no-surcharge rules probably serve to preserve and entrench prevailing market structures and reduce the contestability of such markets to potential new entrants.

Any entry cost that is unrecoverable is a sunk cost. The need to sink costs into a new firm imposes a difference between the incremental cost and the incremental risk that are faced by an entrant and an incumbent.[81] In the case of an incumbent, such funds have already been expended and are already exposed

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[76] Reserve Bank of Australia (2001) *Reform of Credit Card Schemes in Australia I: A Consultation Document*. Sydney, December, p. 66.

[77] Wright, J., *op cit.*, 44-64, pp. 59-60.

[78] Reserve Bank of Australia, *op cit.*

[79] Bain, J. S. (1956) *Barriers to New Competition*. Harvard University Press, Cambridge, Massachusetts.

[80] Church, J. and Ware, R. (2000) *Industrial Organization: A Strategic Approach*. Irwin McGraw-Hill, Boston, p. 487.

[81] Baumol, W. J. and Willig, R. D. (1981) Fixed Costs, Sunk Costs, Entry Barriers, and Sustainability of Monopoly. *The Quarterly Journal of Economics* 96, 405-431, p. 418.

to whatever risks the market entails.[82] In contrast, the new firm must incur any entry costs on entering the market that incumbents do not. Baumol and Willig contend that entry will occur in the event the profits expected by a successful entrant outweigh the unrecoverable entry costs that will be lost in the case of failure, and therefore conclude that the need to sink costs can constitute a barrier to entry.[83]

We believe that there are most likely to be significant sunk costs in terms of advertising and marketing for new providers of credit and charge card payment platforms. It is likely that the prohibition on no-surcharging rules will constitute a further barrier to new entrants.

To establish a new payment card system there is the need to attract both merchants and cardholders, which has been expressed by Rochet and Tirole as the need to get both sides on board. In order to attract cardholders to a payment card platform a platform needs to provide inducements including widespread acceptance by merchants. In order to attract merchants to a new payment card platform, the platform needs to deliver cardholders in order to make it a value proposition for the merchant. As Evans has observed:

> The card is worthless to individuals if few merchants take it and is worthless to merchants if few individuals use it.[84]

According to Evans, the positive feedback effects between both sides in a two sided market and the fact that a firm must succeed on both sides makes entry difficult.[85] Evans observes that building up critical mass on multiple market sides is hard.[86]

Payment card platforms have traditionally discouraged merchants from charging cardholders for card usage through such measures as no-surcharge rules. These rules have been enacted with the express purpose of attracting new members/cardholders to a payment card platform. A continuing prohibition on no-surcharge rules makes the task of establishing a new payment card platform even more difficult than it would otherwise be, because potential new members/cardholders would probably perceive little value in a card that was subject to regular and widespread surcharging by merchants. In turn, a vicious cycle would develop through negative feedback with merchants reluctant to accept a payment card with few members.

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[82] *ibid.*, p. 418.

[83] *ibid.*, p. 418.

[84] Evans, D. S., *op cit.*, p. 350.

[85] *ibid.*, p. 366.

[86] *ibid.*, p. 363.

There is some anecdotal evidence that the RBA's rule changes may have had an adverse effect on potential new entry by payment card providers in Australia. According to an article in *Cards International* from February this year:

> There is … evidence that major offshore card issuers have bypassed the Australia market because of the protracted nature of the RBA reforms, preferring to enter markets where conditions appear more stable.[87]

Existing payment card platforms such as the credit card schemes have built their businesses, attracting customers on both sides of the market, through rules such as no-surcharging imposed on merchants. However, given the RBA's current prohibition on no-surcharging rules, the opportunity for new credit and charge card platforms to build their businesses with the assistance of no-surcharge rules is not possible. Arguably, new entrants will not face a level playing field as they will be prohibited from using the same marketing device of a no-surcharge rule that has enabled incumbents to build their existing businesses. It is possible that the RBA has granted a first mover advantage to incumbents in perpetuity that is now incapable of ever being replicated by new entrants, thus possibly creating a prohibitive barrier to entry.

[87] Halverson, G., *op cit*.

6 Regulation of Other Payment Systems

Paragraph 126 of the RBA issues paper comments:

> … the Bank has not formally regulated American Express and Diners Club, or the BPAY system. The Bank is seeking views on whether these schemes should be formally regulated.
>
> Submissions on this issue could usefully outline any public policy case for regulation of these schemes and consider what aspects of the schemes' activities might be subject to regulation and how they should be regulated.

6.1 The Case for Regulatory Intervention

Government regulatory intervention has usually been predicated on three main policy grounds:

- Ameliorating market failure
- Provision of public goods[88]
- Redistribution of income

The RBA has no specific responsibilities in relation to the redistribution of income, which generally lies in the domain of the Commonwealth Government's responsibilities under taxation and social security laws. Hence, intervention to regulate American Express under the pretext of redistribution of income is highly unlikely to be the primary policy rationale.

Similarly, the regulation of American Express is unlikely to be justified under the pretext of the provision of public goods. While some of the services provided to the community by the RBA could be considered as public goods, American Express is not a provider of public goods and hence intervention to regulate American Express on these grounds is highly unlikely.

By a process of elimination, this arguably leaves market failure as the only credible policy grounds upon which the RBA could justify intervention to regulate the activities of American Express. The Commonwealth Government has given the RBA explicit powers to intervene in the payments system on the policy grounds of market failure under its Payments System Board responsibilities under the *Reserve Bank of Australia Act 1959* ("the Act"). Under section 10B(3)(a) of the Act, the RBA's payments system policy is to be "directed to the greatest advantage of the people of Australia". Under sections

[88] Arguably the provision of public goods is a subset of market failure but is often cited in its own right.

10B(3)(b)(ii) and 10B(3)(b)(iii) the RBA is charged with promoting the efficiency of the payments system and with promoting competition in the market for payment services. This would suggest that any policy intervention on the part of the RBA to regulate the activities of American Express would be on grounds of efficiency and/or competition. In turn, regulatory intervention on grounds of efficiency and/or competition could only likely be justified if in the event American Express is able to exercise substantial market power.

According to the Productivity Commission, prices oversight activities by various governments around Australia are now focused on addressing monopolistic pricing.[89] In regard to the Commonwealth Government's prices oversight legislative functions, the Productivity Commission concluded that its primary focus was upon pricing by firms with substantial market power in markets of national significance.[90]

The case for regulating American Express ultimately rests on its ability to exercise substantial market power, which is consistent with existing Commonwealth Government policy. The next section will consider whether American Express can exercise substantial market power.

6.2 Does American Express Exercise Substantial Market Power?

Within the industrial organisation literature, Lerner[91] was the first to articulate the now traditional definition of the exercise of market power as the ability on the part of a firm to sell a product above marginal cost. However, it is often difficult to measure marginal cost in the real world. In addition, if payment card platforms constitute two-sided markets, then the conditions identified by Lerner for the exercise of market power no longer apply.[92]

Another definition of market power provided by Landes and Posner is "the ability of a firm to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded".[93]

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[89] Productivity Commission (2001) *Review of the Prices Surveillance Act 1983*. Report no. 14, AusInfo, Canberra, p. 24.

[90] *ibid*., p. 26.

[91] Lerner, A. P. (1934) The Concept of Monopoly and the Measurement of Monopoly Power. *The Review of Economic Studies* 1, 157-175.

[92] Evans, D. S., *op cit*., p. 343.

[93] Landes, W. M. and Posner, R. (1981) Market Power in Antitrust Cases. *Harvard Law Review* 94, 937-996.

Competition authorities around the world have adopted other tests that they use as proxies for the exercise of market power, particularly in regard to their assessment of mergers and acquisitions for compliance with competition law statutes. By any of the standard tests used by competition authorities around the world in their merger assessment processes, American Express falls far short of a firm that could conceivably exercise substantial market power considered detrimental to society. This is the case whatever side of a two-sided market is being considered.

For the ease of exposition it will be assumed that the relevant markets under consideration are for credit and charge card issuing and credit and charge card merchant servicing. However, it could be argued that relevant markets could be far wider and also include all commonly accepted payment cards such as debit cards. It could even be argued that the relevant market is far wider still with commonly accepted non-cash payment options such as cheques exhibiting a high degree of substitution with payment cards.

The degree of market concentration is commonly used in market competition assessments of mergers in order to identify the scope for a merged entity to exercise substantial market power in a post-merger environment. In Australia, the national competition law enforcement agency, the ACCC has established two safe harbours for mergers unlikely to result in a competitive detriment (or in the terminology of section 50 of the Trade Practices Act a substantial lessening of competition).[94] In regard to the ability of a firm to exercise unilateral market power, which the ACCC has defined as the ability for a firm to profitably raise prices unilaterally and "give less and charge more" without such a price rise being undermined by competing suppliers, a firm has to be in a position to supply 40 per cent or more of the relevant market. In regard to the ability of a firm to exercise collective market power in concert with other firms behaving in a tacit or overtly collusive manner, as has been postulated in several theories relating to the behaviour of oligopolies, the safe harbour is that the merged entity has a market share less than 15 per cent and the four largest firms have a market share of less than 75 per cent.

In terms of credit and charge card issuing, American Express falls far short of breaching any of the concentration thresholds used by the ACCC. According to an article published in *Cards International* in February this year, American Express cards represented just over 8 per cent of all credit and charge cards issued in Australia.[95] On this basis, American Express falls well within the safe harbours of the ACCC for the exercise of unilateral and collective market power.

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[94] See: Australian Competition and Consumer Commission (1999) *Merger Guidelines*. Canberra.

[95] Halverson, G., *op cit*.

In regard to the number and value of credit and charge card transactions, the relevant market share of American Express is aggregated with Diners Club in statistics published by the RBA. Based on the number of credit transactions, the combined market share of American Express and Diners Club has averaged 12.3 per cent in the year to the end of May 2007. On this basis, American Express falls well within the safe harbours of the ACCC for the exercise of unilateral and collective market power. On the basis of the value of credit transactions, the combined market share of American Express and Diners Club has averaged 16.3 per cent in the year to the end of May 2007. On this basis, American Express also falls within the safe harbour for the exercise of unilateral market power and is highly unlikely to breach the safe harbour for the exercise of collective market power (on the assumption that Diners Club market share exceeds 1.3 per cent).

Turning to the merchant servicing side of the market, one means of testing for market power is to consider whether American Express has the capacity to raise prices profitably to merchants in the manner described by Landes and Posner. According to the criterion set out by Landes and Posner it would be extremely difficult to substantiate an argument that American Express exercises market power. Recent experience suggests that it is subject to an effective competitive constraint imposed by the merchant service pricing of the four party credit card schemes.

If American Express could exercise market power then it could ignore reductions in merchant service fees provided by the four party credit card schemes. However, American Express has not found it profitable to ignore price reductions provided by the credit card schemes in merchant service fees and has responded to such moves by reducing its own merchant service fees. This suggests that there is not a break in the chain of substitutability between American Express cards with the four party credit card schemes and that the four party credit card schemes impose an effective competitive constraint on the merchant service pricing of American Express. Since March 2003, American Express has consistently been lowering its merchant service fees in response to the lower merchant service fees charged by the four party credit card schemes. The fact that they have had to reduce merchant service fees in response to similar moves by the four party credit card schemes is powerful evidence in disproving the notion that American Express can exercise substantial market power. The RBA's predictions that reductions in credit card interchange fees flowing through into lower credit card merchant service fees would precipitate a reduction in the merchant service fees charged by American Express have turned out to be correct.

A further constraint on American Express in terms of setting merchant service fees is the practice of multihoming, where a proportion of end users on one or

two sides of the market are connected to several payment card platforms. For example, some merchants may accept both American Express and VISA (or MasterCard), while many consumers possess both an American Express card and a VISA (or MasterCard) credit card. If American Express was to unilaterally raise its merchant service fee, merchants may become inclined not to accept the American Express card and opt to just accept the VISA card (and/or MasterCard).

6.3 Conclusion

We submit that the evidence suggests that American Express cannot exercise substantial market power using the criteria generally applied and that the case to regulate American Express on the basis of a market failure is therefore extremely weak.

7 Self-Regulation

Paragraph 121 of the RBA's issues paper comments:

> the Bank has always been keen to explore voluntary solutions wherever possible.
>
> Submissions on this issue may therefore wish to comment on whether and why self-regulatory solutions are now feasible in a number of areas where, to date, regulation has been required.
>
> Submissions may wish to address any roadblocks to self-regulation and the nature of possible self-regulatory solutions.

The academic literature on two-sided markets shows that the RBA's current approach to setting credit card interchange fees based on a cost-based pricing methodology is inappropriate. On this basis, it would be preferable to see some sort of self-regulation for the setting of credit card interchange fees than allow the present arrangements to continue. The concerns previously expressed by the Productivity Commission in relation to imposing price regulation should be relevant to the RBA's considerations on future regulatory options.

One concern expressed regarding price regulation is the difficulty of collecting information to undertake the task of setting an efficient price in a non-competitive market. According to the Productivity Commission:

> this is a complex task requiring information that typically is not available. So, in practice, regulators are likely to end up setting prices above or below the efficient level. Yet if they are set too high, consumers are penalised, unless there is a market response which drives prices down. For firms that use the good or service, it could impede their performance and discourage investment. If prices are set too low, investment can be discouraged and firms may exit the industry, leading to more severe

> problems for consumers and the economy generally in the long term, including limited capacity, less innovation or inadequate maintenance or new investment.[96]

The problem of information collection required to perform the price regulation function is likely to be exacerbated in the case of two-sided markets. According to Evans, the determination of social-welfare-maximising prices in two-sided markets needs consideration of marginal costs on all sides along with demand characteristics which creates an onerous information problem for a regulator.[97]

The Productivity Commission has also expressed reservations regarding the utility of attempting to set an efficient price where there is a high degree of uncertainty about how to set an efficient price:

> The Commission's judgement is that, when there is a high degree of uncertainty about how to set the efficient price, there are likely to be smaller economic costs in the long term if prices are not controlled when perhaps they should be, compared with situations where they are controlled when there is no need.[98]

Given that the RBA's current approach to setting credit card interchange fees is under serious challenge from the academic literature on two-sided markets, the concerns raised by the Productivity Commission are particularly relevant to the current regulatory arrangements for payment card platform networks.

According to the Productivity Commission, the limitations of price control create a significant risk of inappropriate investment patterns, reduced incentives to provide improved or new products and poor operational efficiency.[99] The available academic literature on two-sided markets suggests that there is a real danger that these significant risks could have already been realised or could be realised in the future.

Because of the risks posed by inappropriate regulation, ACIL Tasman believes it is preferable for a self-regulatory arrangement to be introduced for the setting of credit card interchange fees.

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[96] Productivity Commission, *op cit.*, p. XVII.

[97] Evans, D. S., *op cit.*, p. 345.

[98] Productivity Commission, *op cit.*, p. XVIII.

[99] *ibid.*, p. 32.