

# WOOLWORTHS LIMITED

A.B.N. 88 000 014 675

31 August 2007

Ms Michele Bullock  
Head of Payments Policy Department  
Reserve Bank of Australia  
65 Martin Place  
Sydney NSW 2000

Dear Michele,

## Re. Review of the Reforms to Australia's Payments System

Woolworths makes the following comments in response to the Reserve Bank of Australia's (RBA) media release on 29 May 2007 which requested submissions as part of the Bank's review of the Australian payments system. 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 largest merchant, with annual group sales of over \$40 billion. Woolworths owns its own PINpad devices, and is in the process of implementing a switch and bilateral interchange links with major issuers to allow it to become a direct participant (self-acquirer) in Australia's EFTPOS network.

Woolworths considers the RBA's reforms to-date to be an overwhelming success. In particular, the new standards introduced by the Bank have achieved their stated intentions. One obvious improvement to the payments industry as a result of the RBA's reform process has been an increase in the level of understanding and awareness about the costs of individual payment instruments. Woolworths encourages the Bank to continue using its carefully measured approach to assess Australia's payment systems.

The level of competition in both the card acquiring and issuing markets has notably increased since the Bank's reforms took effect. This is evidenced by the average Visa and MasterCard merchant service fee falling by more than the credit card interchange benchmark, and the introduction of 'low-rate' credit cards. This increase in competition has benefited consumers.

The Bank should feel vindicated in the action it has taken. As a result, numerous other countries around the world are also reviewing their own payments systems, reaching similar conclusions and implementing comparable policies.

## 1 Interchange

Woolworths supports the position of Dr Alan Frankel, who has provided comments as part of the AMPF submission to the RBA's review process. Woolworths advocates that transactions made by credit cards, Scheme and EFTPOS debit cards, prepaid cards and ATMs are exchanged without



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interchange. In addition, Woolworths believes that contactless payments, and any other new payment instruments, should also be free of interchange. This will bring Australia's card payments systems into line with Australia's bulk electronic clearing system, cheque clearing system, high value clearing system and the exchange of cash as payments systems that exchange at par-value.

Woolworths believes that there is no justification for the exchange of interchange payments from acquiring to issuing parties. Interchange works to separate the user of a payment instrument from the cost of its usage, and consequently promotes sub-optimal usage levels of payment instruments. Interchange has encouraged credit card usage to a level above that which would prevail in a market with prices accurately reflecting costs, and hence above the optimal level of credit card usage. This is because issuers have used interchange to fund heavy promotion of credit cards and generous rewards programs.

Under a no-interchange solution for cards, the card issuer would recover its costs off the cardholder instead of the merchant, and the card acquirer would continue to recover its costs from the merchant. Card usage would be determined by a usage price which reflects the resource costs attributable to making a card payment; this is not the case presently.

The immediate impacts of abolishing interchange fees will be to reduce the level of issuer revenues and hence marketing activity, both inefficiencies, as well as to increase the fidelity of payment instrument price signals and reduce the level of cost passed on to retail prices as a result of credit card usage, both efficiency gains. The net result of these impacts is an unambiguous net increase in social welfare which will ultimately accrue to consumers.

## 1.1 Funding the Interest-Free Period

Should the Bank decide against a no-interchange outcome, Woolworths considers it crucial that the Bank reassesses the composition of the credit card interchange benchmark. In particular, Woolworths considers it inappropriate that merchants should fund the cost of the interest-free period. The benefit of the interest free period accrues almost entirely to the cardholder and issuer. The cardholder is given the option of delaying final payment for transactions by the duration of the interest free period, and this means a reduction in their cost of foregone interest income. The interest free period is an additional feature card issuers offer to entice potential cardholders, and may lead to the issuer earning interest revenue if the cardholder unintentionally leaves payment of the bill until after the interest free period has lapsed. The only possible benefit merchants could obtain from funding cardholder interest free days is that some liquidity-constrained cardholders may bring forward their purchases by the length of the interest free period.

Clearly, cardholders are the major beneficiary from the interest free period and it is appropriate that they pay for this feature on a user-pays basis. Given the fact that different card products have interest free periods that vary in duration, it is appropriate that each issuer charges the cardholder based on the number of interest free days extended, rather than all issuers receiving interchange payments based around a benchmark which incorporates an interest free period cost that is weighted across all products.



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If the benefit from the interest free period really does accrue to merchants, as some parties have claimed, then merchants should be content to fund this cost. Merchants are not willing to continue to fund this benefit to credit cardholders, and this in itself demonstrates that merchants do not believe they are benefiting from this feature.

Upon removal of the interest free period from the interchange benchmark, issuers are likely to reconfigure their product offerings. Cardholders who value the credit facility on a credit card will pay the cost of interest for the full number of days for which credit is extended, just as many cardholders presently make use of the credit facility on their credit card and pay interest after the interest free period has lapsed. In fact, the incidence of cardholders paying interest at present is widespread, and also extremely profitable to issuers.

## 1.2 Fraud Costs

Similarly, Woolworths also believes the cost of fraud should be removed from the credit card interchange benchmark if interchange persists. At present, merchants pay for the cost of any fraudulent transactions, via chargebacks, for which they have not fully met the standard card acceptance procedures. In addition to this, merchants fund issuers' fraud and fraud prevention costs as a component of the interchange benchmark.

While merchants can control their own fraud prevention measures, and hence minimise their cost of chargebacks, they have no control over issuers' fraud costs. In fact, by funding issuers' costs of fraud, the incentive for issuers to minimise their cost of fraud is removed. As a result, there has been very little urgency amongst the industry to introduce industry-wide measures to combat fraud, as evidenced by the delays experienced in introducing EMV, 3DES and PIN authorisation of Scheme cards.

Woolworths proposes that each party to a card transaction should self-insure for the costs of fraud for which they may incur, just as merchants currently make provisions for their cost of chargebacks. By doing so, incentives will be properly aligned such that the party capable of reducing a particular fraud cost has the incentive to do so.

Woolworths endeavours to minimise its cost of chargeback transactions. In the financial year 2006/07 Woolworths' received \$17 billion in card payments at its supermarkets, liquor and petrol outlets, and Woolworths' acquirer disputed the legitimacy of \$1.79 million in card transactions. Of these disputed transactions, only 6%, or a paltry \$116,000, were charged back to Woolworths.

## 1.3 Cash Withdrawal Services

Woolworths believes that the interchange fee for EFTPOS cashout transactions should not be removed unless the interchange fee for ATM transactions is also removed. Both ATMs and cashouts are substitutable methods for cardholders to withdraw cash. If merchants no longer receive interchange as compensation for the costs of providing the EFTPOS cashout service to customers, and ATM owners continue to receive interchange, then EFTPOS cashouts become a very unattractive service for merchants to offer. It is likely that in this scenario, most medium-



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large retailers would prefer to install an ATM on their premises and cease to offer cashout via EFTPOS.

## 1.4 EFTPOS and Scheme Debit Interchange

Woolworths, like many others in the payments industry, is deeply concerned that the current differential between Scheme debit and EFTPOS interchange will encourage more issuers to replace their EFTPOS cards with Scheme debit cards, bringing a premature end to the EFTPOS system as we know it. At present the interchange differential represents a large incentive for banks offering transaction accounts to issue Scheme debit cards over EFTPOS cards. In fact, ANZ and Westpac have introduced Scheme debit products since the Bank's reforms commenced, and Westpac has replaced its EFTPOS cards with Scheme debit cards.

There has always been a differential between Scheme debit and EFTPOS interchange, and in the past the gap has been larger. However, since the commencement of the Bank's reforms, credit card interchange revenue has been reduced considerably and some issuers have partially offset this reduction by migrating their EFTPOS users to a Scheme debit product.

Woolworths' no-interchange proposal would neatly address the interchange differential between Scheme debit and EFTPOS. By placing EFTPOS and Scheme debit on a level competitive platform, the success of these products will be determined by their product features and price, not the interchange spread.

Should interchange be maintained, Woolworths considers it essential that Australia adopts New Zealand's approach, whereby all Scheme debit transactions made at the point of sale are processed via the low-cost EFTPOS network. This would mean all debit card transactions made at the point of sale incur the same interchange fee. Scheme debit transactions would, however, likely continue to result in both the issuer and the merchant, via their acquirer, paying a Scheme fee.

## 2 The Honour All Cards Rule

The Honour All Cards Rule (HACR) should be removed in its entirety. The HACR is an anti-competitive device used by the card Schemes to force merchant acceptance of high cost products that may not be an attractive proposition to merchants based on their own merits. The HACR deprives merchants of their right to control their input costs and choose which payment instruments they will accept from customers. The decision as to which payment instruments will be accepted from customers rightfully belongs to the owner of the merchant business, subject to the influence of customer preferences and the acceptance decisions made by competing merchants.

Just as a cardholder decides to use their card for payment, and a card issuer decides to market its card product, and a card acquirer decides to market its card processing service, so a merchant should be free to decide which payment methods it will offer to customers based on the commercial terms of acceptance for each product. Woolworths should not be subject to a rule which compels it to accept a variety of payment cards via its acquirer at varying commercial terms,



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just as Woolworths' other suppliers do not and cannot force it to stock all of their products. The HACR acts as a deprivation to the fundamental principles of fair competition.

While the RBA has reduced the limitations on merchants stemming from the HACR, this rule has not been completely removed. So long as there are different interchange fees for different product categories, and a merchant is not able to choose amongst these categories as to which product categories it will accept, then the HACR remains. For instance, a merchant may decide whether it wishes to accept all credit cards, but within credit cards there are different sub-categories such as standard, premium and commercial cards, each with their own interchange rates. As yet, merchants are not able to choose between these sub-categories of credit cards. In addition, the card Schemes claim they are allowed to tie acceptance of prepaid cards to debit cards, even though they acknowledge prepaid cards as a separate product category to debit cards.

The absence of card interchange would make merchants less likely to take the drastic step of refusing to accept a payment instrument. However, regardless of the existence of interchange or not, the in-store acceptance decision rightfully belongs to the merchant and the HACR contravenes this right.

### 3 Network Choice

Acquirers are required, by Scheme rules, to process point of sale transactions made using a Scheme card through the network whose branding appears on the card. This requirement eliminates competition between card networks to process card transactions, and in turn shelters acquiring Scheme fees from competitive forces. This absence of competition has enabled the card Schemes to increase their acquiring Scheme fees in recent years. These increases have been funded by merchants and not acquirers, because acquirers pass on to their merchant customers the cost of Scheme fees.

The decision as to which network is used to process card transactions belongs to the acquirer because it is charged for the cost of network processing via the acquiring Scheme fee. A competitive acquirer will route its card transactions through the lowest cost processing network in order to minimise the price it charges to its merchant customers.

Woolworths proposes that the RBA introduces a standard to provide acquirers and self-acquirers with the freedom to choose which network they use to process their card transactions. This would create meaningful competition between the card Schemes, and expose Scheme fees to competitive pressure. It would also provide encouragement to the payments industry to restructure and invest in the EFTPOS network, to allow it to compete with the processing networks of the card Schemes.

### 4 Scheme Fees

Woolworths believes that acquirers' Scheme fees should not be payable for 'on-us' transactions. These transactions do not pass through a scheme for processing, instead they are transmitted



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directly to the issuer's card product system, and as such there should be no processing fee paid to a Scheme.

Woolworths also considers it necessary that Scheme fees are monitored if these fees are not exposed to competitive forces by providing acquirers with network choice. If Scheme card interchange rates are reduced further or removed altogether, then Woolworths holds concerns that Scheme fees could be further inflated and used to fund rebates to issuers in order to bypass interchange. Under such a scenario, Woolworths recommends the Bank should monitor the level of Scheme fees to prevent this practice from happening. Another alternative is to prohibit Scheme fees paid by acquirers from exceeding Scheme fees paid by issuers.

## 5 Benefits to Woolworths' Customers of Reduced Merchant Service Fees

The reduction in Woolworths' merchant service fees forms a small part of the overall reduction in Woolworths' cost of doing business over recent years. Woolworths focuses intently on reducing its overall costs, and this reduction in our cost base has been returned substantially to our customers via a reduction in Woolworths' gross margin.

In addition to the reduction in its merchant service fee, Woolworths has also undertaken projects to further reduce its cost of payments acceptance. These projects include the development of Woolworths' own payments switch, and the roll out of new PINpads and point of sale terminals.

## 6 American Express and Diners

Woolworths is satisfied that the Bank's regulation of 4-party card interchange has in turn led to reductions in overall merchant service fees (MSF) charged by American Express and Diners. Since October 2003, the Bank's reforms have reduced the average credit card interchange fee by 45bp. In response, the average 4-party MSF has fallen by 57bp, the average American Express MSF has fallen by 30bp and the average Diners MSF has fallen by 18bp. Woolworths expects overall American Express and Diners MSF's to continue to decline as merchants' fixed term MSF contracts with American Express and Diners expire and are renegotiated. Woolworths believes that the main reason American Express and Diners MSF's have not matched the reduction in 4-party MSF's is due to the inability of merchants to choose an acquirer for American Express and Diners transactions. Competition amongst acquirers has resulted in overall 4-party MSF's declining by more than the reduction in the credit card interchange benchmark.

Woolworths applauds the RBA's efforts to enable merchants to surcharge American Express and Diners transactions, and similarly to steer these cardholders to other payment methods. As reported in the RBA's *Issues for the 2007/08 Review* paper released May 2007<sup>1</sup>, surcharging for card transactions is no longer uncommon. The ability to surcharge and steer 3-party transactions,

<sup>1</sup> Graph 5: Merchants Surcharging Credit Cards. Approximately 14% of 'very large merchants' were surcharging in December 2006.



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in addition to the reduction in 4-party interchange and MSF's, has enabled merchants to negotiate lower American Express and Diners MSF's, as evident in the RBA's Bulletin Table C3.

Woolworths considers the co-branded American Express and Diners cards issued by Westpac, National Australia Bank and ANZ to be 4-party cards, with the acquirer being American Express or Diners and the issuer being the bank. It is apparent that the banks offering these co-branded cards are performing the key duties of an issuer. Importantly, the payments made by American Express and Diners to the issuers of these cards appear to constitute an interchange payment. On this basis, Woolworths believes that these products should be subject to the Bank's 4-party card regulations.

## 7 Self-Regulation

Woolworths supports payments industry 'self-regulation' to achieve improvements in network structures, technical standards and governance systems.

However, past experience prior to the RBA's intervention in the cards market indicates that an industry governed solution to such issues as interchange, card acceptance and surcharging has not resulted in an equitable solution for all payments system users. The RBA assessed the situation as being so detrimental to the efficiency of the overall payments system as to warrant regulation.

Any relaxation of the RBA's regulations concerning interchange, card acceptance and product surcharging would expose the cards market to the same market failures that prevailed prior to these reforms. Woolworths does not support industry self-regulation of interchange, card acceptance and surcharging.

In recent discussions with a major issuer with whom Woolworths is installing an interchange link, Woolworths was presented with a contractual clause that requires it to accept all cards except for those card categories that the RBA has removed from the HACR. Similarly, the card Schemes still insist that the HACR compels merchants to accept prepaid cards, even though they acknowledge prepaid cards as a separate product category to credit and debit cards. Consequently, Woolworths has serious concerns about the card acceptance conditions it would face in a self-regulated environment.

Around the world, there is considerable and growing interest amongst competition and regulatory bodies in card interchange rates and card acceptance rules, as documented in Table 2 of the RBA's May 2007 *Issues for the 2007/08 Review* document. Remedial policy measures have been implemented in many of these markets to address failures in these markets. Internationally, there has been a tendency for unregulated cards markets to result in high and rising interchange rates, and restrictive card acceptance rules. These conditions are likely to prevail in Australia once again if the RBA's regulations are eased.



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## 8 EFTPOS Network

Woolworths believes Australia's EFTPOS network, and its system of governance, needs to be restructured in order to encourage greater access, competition and innovation. The current bilateral leased-line structure remains an impediment to access, even with the introduction of the new access regime which has assisted new entrants. The bilateral leased-line structure multiplies the effort and cost involved to join the network, and means existing members need to commission a large project to connect a new member. Woolworths is all too aware of the effort required to join the EFTPOS network because it is in the process of becoming a direct participant.

An industry-led upgrade of the EFTPOS network is achievable. Woolworths believes the Bank can play a role by encouraging co-operation amongst all industry participants and monitoring the progress of any industry developments.

Yours sincerely,



Dhun Karai  
Head of Group Financial Services  
Woolworths Limited

