Review of Retail Payment Regulation: Response to Consultation Paper

Dr Alistair Davey

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Pegasus Economics • www.pegasus-economics.com.au • PO Box 449 Jamison Centre, Macquarie ACT 2614

Pegasus Economics is a boutique economics and public policy consultancy firm that specialises in strategy and policy advice, economic analysis, trade practices, competition policy, regulatory instruments, accounting, financial management and organisation development.

The views and opinions expressed in this report are those of the author.

For information on this report please contact:

Name: Dr Alistair Davey

Telephone: + 61 2 6100 4090

Mobile: 0422 211 110

Email: adavey@pegasus-economics.com.au

Table of Contents

Key Points ... iv
- Debit Cards ... iv
- Least Cost Routing ... iv
- Competitive Position of eftpos ... v
- Domestic Debit Card Schemes ... vi
- Competition and Antitrust ... vi
- Buy Now, Pay Later ... vii
- eftpos Future Prospects ... viii

1. Introduction ... 1
2. Recent Developments in the Retail Payments System ... 1
3. Debits Cards ... 6
   - 3.1 Debit Card Schemes ... 6
   - 3.2 Evolution of the eftpos Scheme ... 7
4. Least Cost Routing ... 9
5. eftpos Challenges ... 14
6. eftpos Market Position ... 17
7. Domestic Debit Schemes ... 20
   - 7.1 International Experience ... 20
   - 7.2 Why Domestic Card Schemes Can Struggle to Survive ... 23
8. Competition and Antitrust ... 24
   - 8.1 Exclusionary Conduct ... 24
   - 8.2 Parallel Exclusion ... 25
   - 8.3 Tying and Bundling ... 27
   - 8.4 Exclusionary Bundling and Parallel Exclusionary Bundling ... 27
   - 8.5 Application of Competition Law to Exclusionary Bundling ... 32
9. Regulatory Response on Debit Card Issues ... 32
   - 9.1 Overview on Regulatory Response ... 32
   - 9.2 Addressing Exclusionary Bundling ... 33
   - 9.3 Dual-Network Debit Cards and Least Cost Routing ... 33
     - 9.3.1 Moral Suasion Versus Regulation ... 34
     - 9.3.2 Dual-Network Debit Cards Versus Single-Network Debit Cards ... 34
     - 9.3.3 Least Cost Routing ... 35
     - 9.3.3 Payment Functionality of Dual-Network Debit Cards ... 35
10. Buy Now, Pay Later ... 36

11. Regulatory Response on Buy Now, Pay Later 37
12. eftpos Future Prospects 39
12.1 eftpos an Effective Competitive Constraint 39
12.2 Preferred Consultation Paper Options Risks Removing the eftpos Competitive Constraint 40
12.3 Alternative Options to Preserve the eftpos Competitive Constraint 42
Bibliography 44
Appendix I: Overseas Regulatory Arrangements for Domestic Debit Card Schemes 53
United States 53
European Union 54
Appendix II Australian Case Law on Exclusionary Bundling 55
Australian Competition and Consumer Commission v Baxter Healthcare Pty Ltd [2008] FCAFC 141 55
Appendix III Pass Through 56

Figure 1: Number of Retail Payments by ATM Withdrawals, Credit and Charge Cards, and Debit Cards – January 2014 to May 2021 ('000 seasonally adjusted) 2
Figure 2: Average Total Merchant Fees for Debit, Credit and Charge Cards – March Quarter 2014 to March Quarter 2021 (per cent of transaction value)* 4
Figure 3: Quarterly Average Debit Card Total Merchant Fees – March Quarter 2017 to March Quarter 2021 (per cent of transaction value) 13

Key Points

Debit Cards

- eftpos has consistently charged the lowest average merchant service fees out of all the various card schemes operating in Australia.
- There are two types of debit card systems operating in Australia; the proprietary eftpos scheme and systems operating under the brands of the international card schemes in Visa and Mastercard (Reserve Bank of Australia, 2006).
    - Both types of systems allow cardholders to make payments to merchants from a deposit account held at an authorised deposit-taking institution.
- Dual-network debit cards (DNDCs) are debit/ATM cards that allow transactions to be routed through two different networks (Reserve Bank of Australia, 2016, p. 5). They incorporate the functionality of two networks in one physical card.
- Since 2005 the international card debit schemes have experienced strong growth as the four major banks added international card scheme functionality to their debit cards (Reserve Bank of Australia, 2016, p. 3). This involved switching their standard debit card products from 'proprietary' eftpos/ATM cards to DNDCs.
- DNDCs can route payment transactions through either the eftpos network, or via the networks of Mastercard or Visa debit card schemes.

Least Cost Routing

- Contactless transactions using DNDCs (such as 'tap and go' facility at point of sale) have been primarily processed through the generally higher-cost Visa or Mastercard networks by default, rather than through eftpos (Productivity Commission, 2018, p. 31).
    - Merchants are likely to prefer their financial institutions to route payments through a lower-cost network by default, but most merchants were not given this choice.
- Banks have the ability to program terminals to route contactless payments through the eftpos or international card debit care schemes (House of Representatives Standing Committee on Economics, 2017, p. 4). However, many merchants were prevented from routing debit card transactions through the cheaper eftpos network (Productivity Commission, 2018, p. 491).
- Debit transactions that are processed through the domestic eftpos system are on average less expensive than transactions processed through the international Mastercard and Visa systems, reflecting both lower interchange fees (the fees paid between the merchant's and cardholder's financial institutions each time a transaction is made) and lower scheme fees (the fee that the merchant's bank pays to the payment network) (Reserve Bank of Australia, 2017, p. 36).
- Least-cost routing (LCR) or merchant routing refers to merchants being given the opportunity to route contactless debit card transactions via whichever card network costs them the least to accept (Payments System Board, 2018, p. 41).
- The Payments System Board (PSB) has rejected recommendations from the Black Economy Taskforce, the House of Representatives Standing Committee on Economics, and the Productivity Commission to regulate for the implementation of LCR.
- For financial institutions there may not be strong incentives for the continued issuance of DNDCs and the provision of LCR (Reserve Bank of Australia, 2019, p. 16). For card issuers, there may be incentives to negotiate exclusive single-network contracts with a scheme that offers higher average interchange fees and large upfront financial incentives – such as the international card schemes (rather than eftpos).

- We estimate the potential savings for small and medium sized merchants from LCR is currently around $370 million per annum.
- The competitive tension created by LCR has seen the international card schemes reduce their total merchant service fees from an average of 0.63 per cent (of the transaction value) in the March quarter 2017 to 0.46 per cent in the March quarter 2021.
- The flip side of the potential savings to merchants from LCR is the potential loss of revenue for the international card schemes and card issuers. Under those circumstances, it would be understandable if there was not a lot of enthusiasm on the part of the major banks towards the rollout of LCR.
- There have also been a number of obstacles put in place to LCR by the international card schemes.

Competitive Position of eftpos

- Since eftpos became a formal scheme the international card schemes in Visa and Mastercard have sought to undermine its competitive position in relation to DNDC usage.
- The debit and credit card markets in Australia are dominated by two international card schemes, Visa and Mastercard (Payments System Board, 2020, p. 29). In the debit card market, the share of transactions made using these two schemes has been increasing for much of the past decade, while the share of the domestic debit scheme, eftpos, has been declining.
- The adoption of LCR by a large number of merchants has provided a recent lift in transaction volume for eftpos (Blockey, 2021). This halted the previous trends of declining volume and market share experienced by eftpos across several years (eftpos Payments Australia Limited, 2020, p. 3).
- The share of international card schemes (Mastercard and Visa) has been steadily increasing over time in line with the growth of the overall debit market (eftpos Payments Australia Limited, 2021, p. 19). The rising market share of the international card schemes can be partly attributed to the increasing use of contactless payments, which were only supported by the international debit schemes until eftpos introduced the capability (Payments System Board, 2019, p. 26).
- The Productivity Commission (2018, p. 470) observed that while eftpos was highly price-competitive, recent declines in its market share were concerning and could be attributed to the fact that competition had been stymied by other forces, such as distortions in who pays the costs of card payments.
- Several smaller and mid-sized issuers have begun moving away from DNDCs towards single-network debit cards (SNDCs) which allow payments to be processed through only one of the international debit card scheme networks (Reserve Bank of Australia, 2021, p. 9).
- The future viability of eftpos could be put in jeopardy by the targeted use of strategic merchant rates by the international card debit schemes. When larger merchants adopt LCR and their DNDC transactions are routed via eftpos, they lose access to strategic interchange rates on other debit card transactions that continue to be processed through the international networks; the latter transactions would include transactions on DNDCs where the customer actively selects the international network or where routing is not possible because they are online or due to some problem with the chip or the issuer as well as transactions on SNDCs (Reserve Bank of Australia, 2021, p. 10). This risks reducing the benefits and undermining the attractiveness of LCR for large merchants and in turn reducing the capacity of eftpos to compete for the business of smaller merchants.

- When card issuers have introduced new functionality – such as enabling Apple Pay for cardholders – they have often done so first for the international card schemes, with no firm plans for also enabling eftpos (Reserve Bank of Australia, 2019, p. 16). This in turn raises the prospect that LCR can be "neutralised" through the growing prevalence of mobile wallets (Blockey, 2021, p. 147).

Domestic Debit Card Schemes

- As is the case in relation to eftpos, domestic debit card schemes around the world are feeling increasingly strong competitive pressure from Visa and Mastercard, who continue to encourage issuing banks to move to their debit card schemes in order both to provide increased functionality to their customers (e.g. contactless cards, cross-border and online payments, fraud management, and consumer marketing promotions) and to gain the benefits of the international schemes' (e.g. higher revenues [on both domestic and cross-border transactions] marketing and product development support, and access to tokenisation and fraud services) (Blockey, 2021, p. 141).
- Most of the remaining domestic debit card schemes around the world have been supported by the active intervention of their local regulator(s) or government authorities (Blockey, 2021, pp. 143-144).
- Regulatory intervention generally takes one of two paths: (i) creating a level playing field; or (ii) actively promoting and favouring the domestic card scheme over the international card schemes.
    - Regulation can promote a level playing field through the adoption of an activity-based approach, as opposed to an entity-based one (Restoy, 2021, p. 2).
- Domestic card schemes can become dominant where an entity-based approach to regulation is adopted that seeks to actively promote the domestic payment card system.
- As is the case in Europe, domestic card schemes can also thrive and prosper where an activity-based approach is taken to regulation while also enjoying active support from their scheme-owning banks.
- Domestic card schemes can sometimes struggle to survive even where an activity-based approach is taken to regulation that seeks to create a level playing field.
- Support from scheme-owning banks for domestic card schemes can be undermined through international card schemes incentivising card issuers with higher interchange fees as has happened in parts of Europe.
- Another reason as to why domestic card schemes can sometimes struggle to survive is provided by the numerous competition and antitrust law investigations and proceedings that Visa and Mastercard are subject to around the world.

Competition and Antitrust

- A primary concern over bundled pricing strategies is that they may foreclose or exclude equally efficient rivals, even if the discount results in prices that are above the dominant firm's costs (Economides & Lianos, 2009, pp. 488-489).
- Courts in various jurisdictions have ruled that bundled discounts may in some circumstances amount to anti-competitive behaviour even when the dominant firm would not be liable under a predatory pricing test (Economides & Lianos, 2009, p. 493).
- Under exclusionary bundling, even if a bundle's components are sold above cost, it could still exclude an equally or more-efficient competitors from entering, or remaining in, one or more component markets (Muris & Smith, 2008, p. 404).

- Exclusionary bundling is effectively the type of conduct Visa was engaging in when it was tying the offer of cheaper strategic merchant rates for credit card transactions to a commitment from the merchant to process Visa branded dual network debit card transactions via the Visa network and not through eftpos.
    - In March 2021 the ACCC (2021a) accepted a court-enforceable undertaking from Visa under section 87B of the *Competition and Consumer Act* in relation to concerns that Visa may have limited competition in relation to debit card acceptance through its dealings with large merchants.
    - The Visa undertaking means that it cannot offer strategic merchant rates for credit card payments to merchants on condition that the merchant processes debit card payments through the Visa network.
- If exclusionary bundling is being practiced by more than one firm, then it becomes parallel exclusionary bundling, also known as multilateral exclusionary conduct.
- The provision of access to strategic interchange rates on other debit card transactions that are not contestable by eftpos based on the agreement of large merchants to continue to rout DNDCs transactions through the debit card networks of the international card schemes that are contestable arguably constitutes tying conduct that could be categorised as not only exclusionary bundling, but also parallel exclusionary conduct as it is currently being practiced by both Visa and Mastercard.
- US antitrust case law has established that a multi-product seller that uses a bundled discount in a way that excludes or eliminates an equally or more efficient competitor unambiguously harms consumers and competition (Dillbary, 2010, p. 1233).
- In Australia the competition law applicable to the practices of exclusionary bundling and parallel exclusionary bundling are sections 46 and 47 of the *Competition and Consumer Act 2010* (CCA).
    - Section 46 prohibits a firm with a substantial degree of market power from engaging in conduct that has the purpose, effect or likely effect of substantially lessening competition in a market.
    - Section 47 prohibits exclusive dealing where it has the purpose, effect or likely effect of substantially lessening competition in a market. In particular, section 47(2) deals with exclusive dealing conduct of supplying goods or services on the condition that the buyer will not acquire goods or services from a competitor of the supplier.
- Exclusionary bundling has previously been successfully prosecuted by the ACCC under the previous version of section 46 as well as section 47 of the CCA.

Buy Now, Pay Later

- ‘Buy now, pay later’ (BNPL) services enable consumers to obtain goods and services immediately and make subsequent payments in a series of interest-free instalments, typically drawn from a linked debit or credit card (Caddy, Delaney, & Fisher, 2020, p. 36).
- While BNPL services may be free or inexpensive for consumers (assuming repayments are made on time), the cost to merchants of accepting BNPL payments may be significantly higher than the cost of accepting other electronic payment methods such as credit and debit cards (Fisher, Holland, & West, 2021, p. 65).
- Consumers who use the cheapest payment systems are likely to end up paying more, and consumers who use expensive payment systems are likely to end up paying less than each set of consumers would otherwise have paid (Levitin, 2008, p. 3). The effect is a cross-subsidisation of those using the most expensive payment systems by those using the cheapest.

- The prices that merchants charge for their goods and services incorporate the costs of running a business, so higher payment acceptance costs lead to higher prices for all customers (Fisher, Holland, & West, 2021, p. 65).
- Most BNPL providers contractually prevent merchants from charging consumers higher prices for using a buy now pay later arrangement – also known as no-surcharge rules – that prevent merchants from passing on these costs to the consumers who use and benefit from BNPL services (Australian Securities & Investments Commission, 2018, p. 10; Fisher, Holland, & West, 2021, p. 60).
- Some card schemes in Australia previously imposed no-surcharge rules upon merchants.
- The Reserve Bank of Australia (RBA) enacted regulations that prevented the Mastercard and Visa credit card schemes and the Visa debit card scheme from prohibiting a merchant from imposing a surcharge for the use of a card. American Express and Diners Club provided the RBA with written undertakings to remove restrictions in their credit and/or charge card schemes preventing merchants from charging any fee or surcharge for the use of a card.
- While the PSB asserts that it long-standing view is that merchants have the right to pass on costs to users of more expensive payment methods that in turn promotes competition and efficiency in the payments system, it justifies its position for doing nothing in the interim in relation to the no-surcharge rules imposed by BNPL providers is that they can sometimes help promote competition in the payments market by helping newer services build up their customer and merchant networks (Reserve Bank of Australia, 2021, p. 4).
- The PSB has reached the view that there is not a clear public interest case for requiring any BNPL providers to remove their no-surcharge rules at this time as they still accounts for a small share of payments in the economy when compared to some other electronic payment methods (Reserve Bank of Australia, 2021, p. 4).
- It appears the PSB is saying there is a limit on its tolerance in relation to the growth and size of BNPL providers, and that if they grow too much and become too prominent in the Australian retail payments system then it will reconsider their exemptions from the prohibition on no-surcharge rules. In other words, there appears to be growth limit on the size of BNPL providers before such time as their exemption from the prohibition on no-surcharge rules is lifted.

eftpos Future Prospects

- As the lowest priced provider of merchant service within the Australian retail payments system, eftpos is a vigorous and effective competitor that provides an effective pricing constraint on the conduct of other card payment schemes. This extends beyond eftpos's own product segment of debit cards to also include credit cards as well.
- The continued competitive pricing and tension currently presented by eftpos is at significant risk if the PSB and the RBA persist with their preferred options as outlined in the *Consultation Paper* as it risks condemning eftpos into oblivion.
- The international evidence is clear that domestic card schemes require government support and/or intervention in some form in order to survive against the international card schemes.
- However, competition between the domestic card scheme and the international card schemes in Australia is not being conducted on a level playing field because: (i) international card schemes are engaging in anti-competitive practices, specifically exclusionary bundling on both a unilateral and multilateral/parallel basis; and (ii) LCR is being implemented through persuasion rather than regulation.

- The creation of a genuine level playing field would mean that eftpos is no longer dependent on further regulatory intervention from the PSB and RBA in order to survive, and would be empowered to pursue its diversification and differentiation strategies.
  - If these strategies prove successful, then eftpos in turn will become less reliant on support from its sometimes unenthusiastic membership.
- The absence of a level playing field and lack of competitive neutrality in relation to BNPL providers also poses a threat to the future viability of eftpos over the medium to longer term.
- The exit of eftpos would provide an opportunity for other market participants to raise their merchant service fees, setting the scene for wholesale price increases across-the-board.
- The removal of the competitive constraint posed by eftpos will turn Australian card payments into an effective duopoly composed of the dominant international card schemes in Visa and Mastercard.
- The international card schemes will be the only remaining domestic debit card schemes and already dominate in relation to domestic credit/charge cards. The remaining providers in the domestic credit/charge card space will be a competitive fringe of even higher priced providers that will provide no effective competitive constraint to the international card schemes.
- The international card schemes currently charge small and medium sized merchants somewhere around 44 basis points more for debit card transactions than eftpos. If, following the exit of eftpos, the remaining international card debit schemes were to increase their merchant service fees by further 44 basis points, similar to what has happened in the UK, then this would increase net merchant service fees for small and medium sized merchants in order of almost $1.2 billion per annum.
- The exit of eftpos would also leave the international card schemes unconstrained to raise prices on their credit card products as well.
- The removal of the competitive constraint posed by eftpos and the subsequent increase in merchant service fees by the international card scheme duopoly will see some of the this increase in costs imposed upon merchants passed through to consumers. This will come in the form of either additional and/or higher surcharges on card payment transactions or higher merchant prices across-the-board.
- There are a number of proactive steps the PSB and RBA can take to preserve the competitive constraint provided by eftpos in the Australian retail payments system.
- The PSB and RBA need to go much further than just prohibiting tying between the credit and debit products of the international card schemes. Competition only has a chance to succeed if a prohibition is also instituted on all tying conduct by the international card schemes between their non-contestable services with their contestable services debit card services as well.
- Despite ignoring the recommendations of the Black Economy Taskforce, the House of Representatives Standing Committee on Economics, and the Productivity Commission to regulate for LCR, the RBA is essentially relying on moral suasion to facilitate the take-up of LCR. The RBA and PSB have received assurances in the past from participants in the retail payments system that have either partially – if not completely – been ignored or reneged upon. On this basis, it should impose an outcome rather an rely on moral suasion and the assurances of unenthusiastic and unmotivated participants.
- If the RBA is concerned about the additional cost imposed upon smaller issuers from supporting two networks in relation to DNDCs, then perhaps eftpos can provide financial

compensation in some form such as through a direct subsidy or tiered interchange rates for smaller issuers to support the continued issuing of DNDCs by such institutions. This would preserve competition and support the continuation of LCR. It would also permit the RBA to pursue a regulatory option far broader than what it currently contemplated by mandating DNDC issuance for even smaller issuers in addition to major and medium sized issuers.

- The small additional cost arising from supporting the continued issuance of DNDCs pales into insignificance from the substantial additional cost that could be imposed on the retail payments system in the event eftpos were to exit, leaving the system at the mercy of the international card scheme duopoly.
- For various reasons, including anti-competitive conduct, lack of motivation on the part of acquirers who are also issuers, customer inertia and informational asymmetries amongst some merchants leading to adverse selection, LCR is not being taken up even though it is arguably in the best interests of most merchants, especially smaller merchants. This provides prima facie evidence of market failure that justifies some sort of regulatory response on the part of the RBA and PSB.
- In order to preserve competitive tensions between the international card debit schemes with eftpos, it is vitally important that both card schemes on a DNDC are provisioned in all form factors and both methods also need to be presented to the merchants, including in relation to online transactions and mobile wallets.
- There is obviously a lack of competitive neutrality at the present time in relation to the treatment of BNPL providers being exempt from the prohibition on no-surcharge rules imposed on other payment schemes. An ongoing lack of competitive neutrality risks entrenching high-cost payment instruments within the Australian retail payments system as well as undermining the competitive position of not only eftpos, but also other payment schemes as well.
- In order to provide business certainty for all participants in the retail payments system, the PSB needs to specify exactly how big BNPL providers need to become before their blanket exemption from the prohibition on no-surcharge rules is lifted.
- The potential loss of the eftpos scheme risks the entrenchment of higher cost payment instruments, in turn imposing higher costs upon merchants and ultimately consumers, with potential flow-on inflationary effects. At a time when the RBA is engaging in quantitative easing – effectively printing money – it is questionable from the perspective of macroeconomic stability as to whether through its willful neglect for the plight of the eftpos scheme that it should also be facilitating the proliferation of higher cost payment instruments.

1. Introduction

Pegasus Economics has been commissioned by eftpos Payments Australia Limited to prepare a report responding to issues raised by the *Review of Retail Payments Regulation – Consultation Paper* in May 2021 by the Reserve Bank of Australia (RBA) (2021). In particular, Pegasus Economics has been asked to address the following issues:

- The economic effect of the RBA's conclusions on merchants and the broader economy
- The economic effect on merchants and the broader economy if eftpos ceased to exist.

The views and opinions expressed in this report are entirely those of the author.

2. Recent Developments in the Retail Payments System

Over the past two decades, the Australian retail payments system has moved from one where the dominant payment methods were cash and cheques to one where electronic payment methods are near-ubiquitous (Reserve Bank of Australia, 2019, p. 2).

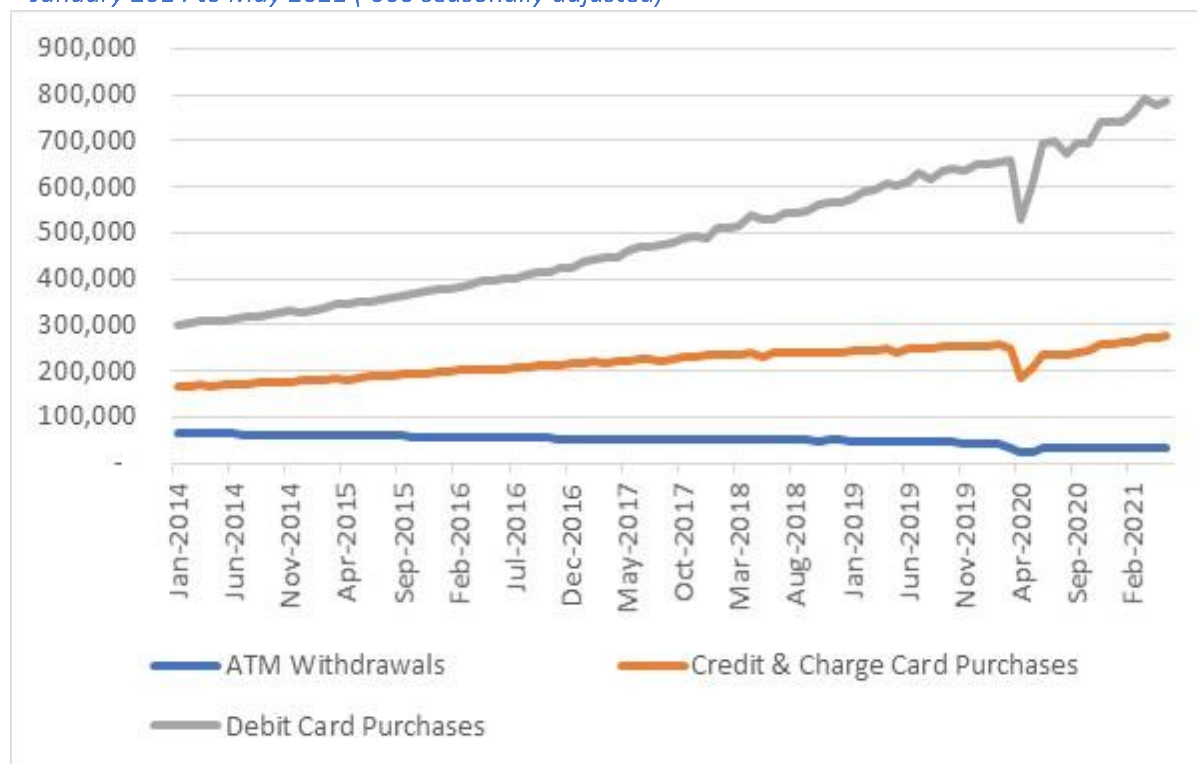
The RBA's 2019 Consumer Payments Survey (CPS) found Australian consumers increasingly prefer to use electronic payment methods rather than cash for their day-to-day payments (Caddy, Delaney, & Fisher, 2020). Many people now tap their cards or sometimes their mobile devices even for small purchases.

Card payments are now the most frequently used payment method in Australia (Reserve Bank of Australia, 2019, p. 1). The shift away from cash has occurred for transactions of all sizes, including for lower-value payments (Caddy, Delaney, Fisher, & Noone, 2020, p. 11). Cards are increasingly being used for smaller value transactions where consumers once used to rely on cash. Cards are now used more often than cash for all payments over $5 (Caddy, Delaney, Fisher, & Noone, 2020, p. 11).

When choosing to pay with a card, Australian consumers are increasingly using debit cards – which allow people to make payments from funds in their deposit account – rather than credit cards (Caddy, Delaney, Fisher, & Noone, 2020, p. 13). In 2019, debit cards were the most commonly used means of payment, overtaking cash as the single most frequently used payment method (Caddy, Delaney, Fisher, & Noone, 2020, pp. 9-10). Debit cards were used for nearly 45 per cent of consumer payments (by number) in 2019, while credit cards accounted for 19 per cent of consumer payments (Caddy, Delaney, Fisher, & Noone, 2020, p. 13).

The most recent evidence suggests that debit and credit card usage has continued to increase despite temporary falls during the onset of the COVID-19 pandemic, while ATM withdrawals are in trend decline. This is outlined in Figure 1 below.

Figure 1: Number of Retail Payments by ATM Withdrawals, Credit and Charge Cards, and Debit Cards – January 2014 to May 2021 ('000 seasonally adjusted)



Sources: RBA Payments Data: C1 Credit and Charge Cards – Seasonally Adjusted Series; C2 Debit Cards – Seasonally Adjusted Series; and C4 ATMs – Seasonally Adjusted Series.

The way in which consumers use their cards has also changed significantly over the past decade or so (Caddy, Delaney, & Fisher, 2020, p. 23). Most in-person card payments are now made using contactless functionality – initiated by tapping either a physical card or mobile phone or other payment-enabled mobile device (e.g. watch) in front of a card terminal – rather than by inserting the card into the terminal and then entering a personal identification number ("PIN"), and consumers are increasingly storing their card details in mobile wallets (Caddy, Delaney, & Fisher, 2020, p. 23; Caddy, Delaney, Fisher, & Noone, 2020, p. 11). Overall, in 2019, 83 per cent of point of sale card transactions were contactless, initiated by tapping a card or mobile device (Caddy, Delaney, Fisher, & Noone, 2020, p. 12).

A "mobile wallet" typically refers to a service that enables payment at a physical point of sale via a mobile device (Fonte, 2017, p. 556). A wallet app is typically capable of storing multiple payment account credentials (e.g., credit card, debit card, prepaid card), and employs various user authentication methods and technology to initiate payment transactions. The widespread adoption of mobile devices has seen the launch of mobile wallets like Apple Pay, Samsung Pay and Android Pay, and the real-time payments app 'Beem It' (Reserve Bank of Australia, 2019, p. 2). In 2019 8 per cent of all in-person contactless payments were made by tapping or waving a mobile device (Caddy, Delaney, & Fisher, 2020, p. 24).

Another type of mobile wallet technology that has emerged in other jurisdictions, but has not yet gained much traction in Australia, is quick response (QR)-code based payments (Reserve Bank of Australia, 2019, p. 3). The most prominent use case for QR code payments in Australia has been a growing number of retailers using them to facilitate payments from tourists from China, where take-up of QR-code based mobile payments has been extensive.

Most of the costs of card payments are paid initially as merchant service fees by merchants, who then in turn will pass those costs on to consumers, either directly (through surcharges) or indirectly (through pricing of goods and services generally) (Reserve Bank of Australia, 2019, p. 1).

The interchange fee is a fee paid by merchant *acquirers* – usually banks who offer card processing services to merchants – to card *issuers* who seek out and encourage customers to use cards (Gans & King, 2003, p. 1). The interchange fee, which can be charged either on the basis of the transaction value or a flat fee, is a marginal cost to acquirers but a revenue source for issuers. Interchange fees are often not transparent; cardholders and merchants do not typically see them (Reserve Bank of Australia, 2019, p. 5).

The merchant's financial institution (acquirer) recoups the cost of interchange fees, as well as other (fixed) costs such as payment terminals by charging the merchant a merchant service fee (Productivity Commission, 2018, p. 468). The higher the interchange fee, the more the merchant pays to accept a card payment.

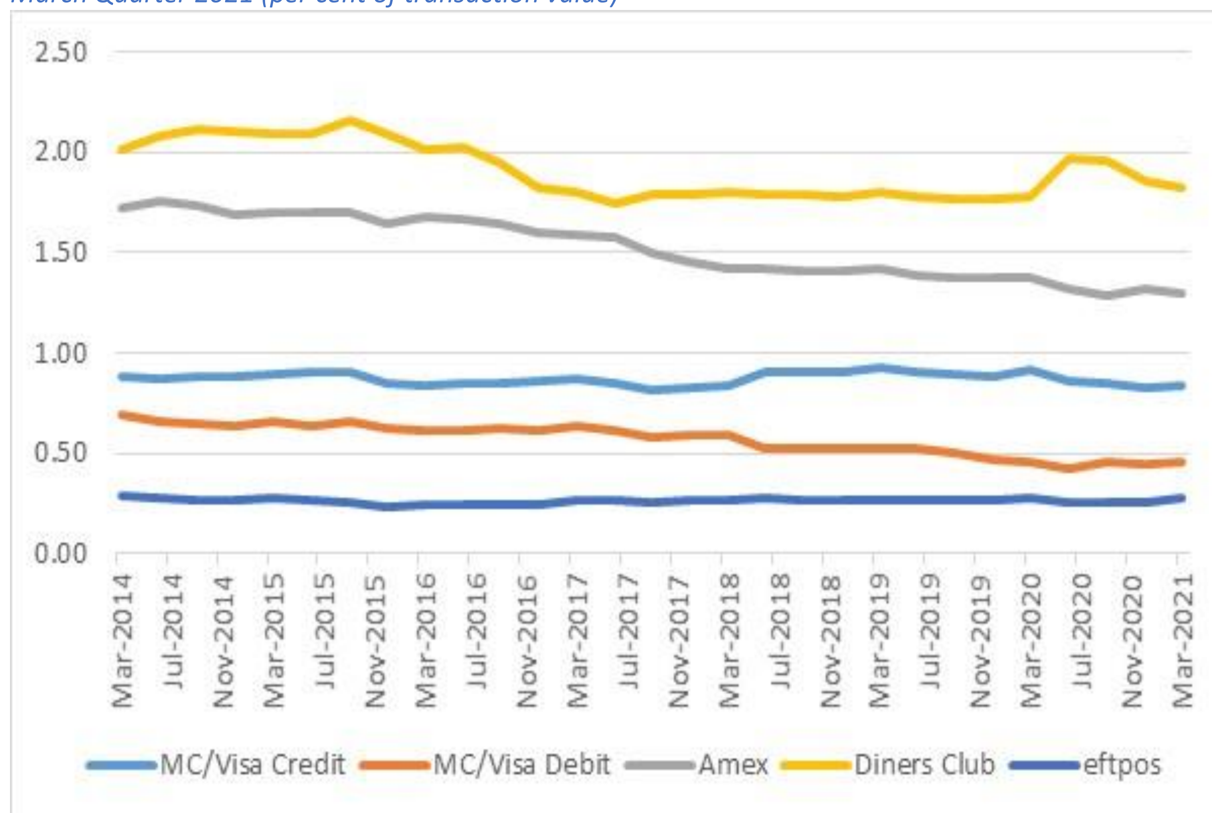
Since the early 2000s, the RBA (2019, p. 6) has had in place weighted-average interchange fee benchmarks to constrain the potential for interchange fees to distort efficient payment choices and to underpin a fall in the overall resource cost of payments. From 1 July 2017 the RBA imposed maximum caps on interchange fees, as a way of addressing some large differences that had emerged between interchange fees that were being paid by small merchants and the lower 'strategic' rates applying to larger merchants (Payments System Board, 2016, p. 35; Reserve Bank of Australia, 2019, p. 6).

In general, credit cards have higher interchange fees than debit cards, and interchange fees for eftpos transactions are lower on average than those for the international card schemes' debit cards (Payments System Board, 2020, p. 36).

The Payments System Board (PSB) (2020, pp. 49-50) reported last year that interchange fees for online debit transactions remain relatively high, as the international card schemes' fees for online transactions with standard consumer cards have both set their interchange fee at the debit card ceiling. This is consistent with the finding from the 2019 CPS that online transactions are sometimes more expensive for merchants to accept (Caddy, Delaney, & Fisher, 2020, p. 27). eftpos was only able to support online payments from August 2020 (eftpos Payments Australia Limited, 2021, p. 10).

eftpos has consistently charged the lowest average merchant service fees out of all the various card schemes operating in Australia, as outlined in Figure 2 below.

*Figure 2: Average Total Merchant Fees for Debit, Credit and Charge Cards – March Quarter 2014 to March Quarter 2021 (per cent of transaction value)**



Source: RBA Payments Data C3: Average Merchant Fees for Debit, Credit and Charge Cards.
* MC – Mastercard, CC – credit card, Amex – American Express charge card, Diners Club – Diners Club charge card.

Payments made through eftpos are generally the least expensive, costing merchants an average of 0.27 per cent of the transaction value in the March 2021 quarter. This compares with an average merchant fee of 0.46 per cent for Visa and Mastercard debit card transactions, and 0.84 per cent for Visa and Mastercard credit card transactions. The American Express and Diners Club charge cards are the most expensive, with average merchant fees of 1.30 per cent and 1.82 per cent of the transaction value, respectively.

It has also previously been found that the cost differential between eftpos and the international card scheme debit networks tends to be largest for small merchants (52 basis points for the smallest merchants, compared to 25 basis points for the largest merchants that have eftpos transactions) (Occhiutto, 2020, p. 25).

The international card schemes in Visa and Mastercard, along with charge card providers such as American Express and Diners Club previously imposed rules on merchants that accepted their cards. One of these rules was known as the *no-surcharge rule* that prohibited merchants from charging more for accepting the card of a particular scheme than for other payment instruments (Bullock, 2010, p. 53). While the operation of this rule in Australia did not prohibit merchants from providing a discount to customers who paid with cash, it prohibited them from charging more for cards that were more costly for them to accept.

The RBA's reforms that took effect in 2003 required card schemes to remove their no-surcharge rules as well as other rules that prevented merchants from steering consumers to lower-cost payment methods (Reserve Bank of Australia, 2016a, p. 30). However, practices emerged in some industries where surcharge levels on some transactions appeared to be well in excess of merchants' likely acceptance costs.

In October 2015, the Commonwealth Government released its response to the Financial System Inquiry, indicating that it would phase in a legislated ban on excessive surcharges, with enforcement to be undertaken by the Australian Competition and Consumer Commission (ACCC) (Reserve Bank of Australia, 2016a, p. 30). The Commonwealth Government also indicated its expectations that the PSB that it would provide clarity around what constituted excessive customer surcharging on card payments. Amendments to the *Competition and Consumer Act 2010* were passed by the Commonwealth Parliament on 22 February 2016 to give the ACCC enforcement power over surcharges that are above the 'permitted surcharge' defined in an RBA standard or in a regulation.

The excessive surcharging ban was applied to large businesses as from September 2016 and was extended to all businesses that are either based in Australia or use an Australian bank as from September 2017 (Australian Competition and Consumer Commission, 2017).

One notable development in recent years has been the emergence of digital 'Buy now, pay later' (BNPL) services (Caddy, Delaney, & Fisher, 2020, p. 36). These services enable consumers to obtain goods and services immediately and make subsequent payments in a series of interest-free instalments, typically drawn from a linked debit or credit card.

With BNPL the customer receives their purchase immediately and the merchant is paid upfront by the BNPL provider (Fisher, Holland, & West, 2021, p. 59). In most cases, customers use a mobile app to access these services and repayments are drawn from a customer's linked debit or credit card. Some popular BNPL services facilitate borrowing of amounts up to $1,000 to $2,000 and may be free for consumers if instalments are paid on time, otherwise late fees may apply. Other BNPL services enable eligible customers to borrow larger amounts but tend to charge establishment or monthly fees (Fisher, Holland, & West, 2021, pp. 59-60).

BNPL is mostly used for online purchases, though some BNPL providers are also focusing on expanding adoption for in-store purchases (which operates via the provider's app by generating a scannable barcode or QR code) (Fisher, Holland, & West, 2021, p. 60). More recently, a number of providers have developed BNPL services that issue virtual cards through the provider's mobile app that can be used more widely for in-store payments, as well as online transactions, at merchants that accept card payments.

The BNPL sector is growing rapidly and new providers and business models are emerging (Fisher, Holland, & West, 2021, p. 59). From the period 2017-18 to 2019-20 the value of payments processed through BNPL services has tripled, reaching almost $10 billion in 2019-20 (Payments System Board, 2020, p. 31). Based on recent public disclosures, the value of transactions processed by some of the large BNPL providers grew by over 50 per cent in the second half of 2020 compared to the same period a year earlier (Fisher, Holland, & West, 2021, p. 60). The best known providers of BNPL services in Australia are Afterpay with 3.5 million active customers in Australia and New Zealand and Zip Co with 2.6 million.[1] Despite strong growth, BNPL still only accounts for a relatively small share of overall payment flows (Payments System Board, 2020, p. 31).

Merchants pay fees to BNPL providers that are typically much higher than the fees they would pay on other payment methods, such as credit and debit cards (Payments System Board, 2019, p. 33). Like the card schemes previously did before the practice was eradicated, most BNPL providers have rules that prevent merchants from levying a surcharge on the customer to recover those fees (Payments System Board, 2019, p. 33).

The 2019 CPS also revealed that the share of consumer payments made online was little changed from previous years, at 13 per cent of the number of payments, while by value online payments accounted for 35 per cent of all consumer payments, down from 39 per cent in the 2016 CPS (Caddy, Delaney, & Fisher, 2020, p. 29). Consumers are increasingly making online payments via mobile

[1] See Afterpay Limited (2021) and Zip Co Limited (2021).

devices and apps: in 2019, 40 per cent of online payments were initiated via mobile apps. App-based payments were relatively common for household bills and for transport-related payments, with the latter consistent with the growth in popularity of ride-sharing apps.

Card payments accounted for 48 per cent of the number of online payments and 39 per cent by value (Caddy, Delaney, & Fisher, 2020, p. 29). Within the figures for cards, the share of online payments made using a debit card increased by 9 percentage points between 2016 and 2019 to 29 per cent, while the credit card share declined over the same period. PayPal was used for a further 14 per cent of online transactions, while BPAY and bank transfers accounted for much of the remaining online payments. Despite strong growth in transaction volumes in recent years, BNPL accounted for just 3 per cent of the total number of online payments (Caddy, Delaney, & Fisher, 2020, p. 30).

As the CPS was conducted in late 2019 prior to the onset of the COVID-19 pandemic, there has been increased use of online shopping as consumers changed their purchasing behaviour and merchants increased their online capabilities in response (Caddy, Delaney, & Fisher, 2020, p. 29). This may have led to a more permanent shift in purchasing patterns for some consumers.

Since the onset of COVID-19 pandemic, anecdotal evidence suggests that there has been some further behavioural change in relation to cash (Bullock, 2020). Both merchants and consumers appear to have been keen to reduce their use of cash. Many merchants made it clear through signage that they preferred contactless card payment, even for low value payments. Some even went as far as to indicate that they would not accept cash.

3. Debits Cards

3.1 Debit Card Schemes

There are two types of debit card systems operating in Australia; the proprietary eftpos scheme and systems operating under the brands of the international card schemes in Visa and Mastercard (Reserve Bank of Australia, 2006). Both types of systems allow cardholders to make payments to merchants from a deposit account held at an authorised deposit-taking institution.

Dual-network debit cards (DNDCs) are debit/ATM cards that allow transactions to be routed through two different networks (Reserve Bank of Australia, 2016, p. 5). They incorporate the functionality of two networks in one physical card. For example, DNDCs can route domestic point of sale transactions either via the eftpos network (if the cardholder pushes the ‘cheque’ or ‘savings’ button) or via the networks of MasterCard or Visa (the ‘credit’ button). These cards typically have logos of both schemes. The international card schemes in Visa and Mastercard have their logos on the front of the card while the domestic debit card scheme in eftpos has its logo on the back. It has been estimated that around 90 per cent of debit cards issued in Australia are DNDCs, allowing a domestic point of sale payment to be processed via either eftpos or one of the international debit card schemes (Reserve Bank of Australia, 2019, p. 14).

The electronic funds at point of sale (eftpos) system was originally built as a series of bilateral links between institutions that issued the cards (issuers) and institutions that provided payment services to merchants (acquirers) (Reserve Bank of Australia, 2005). The first cards were issued in 1984. Initially these cards could only be used to make a purchase at merchants who used the same bank as the cardholder. However, as the system expanded, links between financial institutions were established and cardholders gained access to an increasing number of merchants. By the 1990s, merchants were able to accept cards from all issuers.

Technical standards for eftpos were transferred to the Australian Payments Clearing Association (APCA) in the early 1990s, although APCA never had any kind of marketing or strategic role in relation to eftpos (The Sheet News Bites, 2007).

The eftpos scheme is a purely domestic system, so that it cannot be used to make payments overseas (Payments System Board, 2006, p. 15).

The Visa debit card was launched in 1982 by smaller financial institutions such as credit unions and building societies (St George Bank, Bendigo Bank, Australian Association of Permanent Building Societies, and Credit Union Services Corporation, 2001, p. 8). Mastercard debit card was first issued in Australia by BankWest in November 2005 (House of Representatives Standing Committee on Economics, Finance and Public Administration, 2006, p. 30).

Studies by the RBA undertaken from 2000 to 2002 concluded that the structure of pricing in the Australian card payments system was encouraging inefficient use of credit cards relative to eftpos (Bullock, 2010, p. 51). This was despite the eftpos system having lower resource costs (Reserve Bank of Australia, 2007, p. 5). The RBA (2014, p. 204) considered that the large gaps that existed between the fees charged in the eftpos, international card scheme debit and credit card systems were not justified by costs and sent inefficient price signals to customers and merchants.

While a number of factors contributed to this pricing structure, the RBA (2007, p. 5) concluded that one important factor was the structure of interchange fees – the fees paid between the merchant's and cardholder's financial institutions each time a transaction is made. At the time, in the international card scheme debit and credit card systems, the interchange fee averaged around 0.95 per cent of the transaction value flowing from the merchant's financial institution to the cardholder's financial institution. In contrast, in the eftpos system the interchange fee flowed in the opposite direction – from the cardholder's financial institution to the merchant's financial institution – and averaged around 20 cents per transaction.

In April 2001, the PSB designated the Bankcard, MasterCard and Visa credit card schemes, enabling it to set standards for these schemes (Reserve Bank of Australia, 2014, p. 204). However, the PSB later made the decision to exempt Bankcard from regulation in April 2006 following its announcement that it would close in early 2007 (Payments System Board, 2006, p. 15).

In August 2002, the PSB decided that from July 2003 the international card scheme credit cards would be subject to a standard which set an interchange fee benchmark for each scheme and increased transparency of these fees (Reserve Bank of Australia, 2014, p. 204). The benchmark was based on the average costs of the issuers of each scheme.

Reforms of the debit card systems began in 2004, with the PSB designating the Visa debit system in February and the eftpos system in September (Reserve Bank of Australia, 2014, p. 204). Historically, interchange fees in the international card debit scheme systems had been the same as those for credit cards (Reserve Bank of Australia, 2007, p. 9). However, the RBA could not see a case for interchange fees for international card scheme debit transactions being the same as those for credit card transactions. A particular concern was that the eftpos system was at a significant disadvantage to the international card scheme debit systems, simply because of the structure of interchange fees, which themselves were not subject to the normal forces of competition.

In July 2006, the PSB introduced interchange standards for each debit system and in 2013 a new standard took effect for the eftpos system to reflect structural changes to that system (Reserve Bank of Australia, 2014, p. 204). The debit Mastercard system was formally designated in October 2015.

The effect of these changes was to increase the price to cardholders of using a credit card relative to eftpos, thereby reducing the incentive to use the more costly payment instrument (credit card) over the less costly one (eftpos) and reducing the overall cost of the payments system (Bullock, 2010, p. 51).

3.2 Evolution of the eftpos Scheme

Traditionally, eftpos transactions accounted for the vast majority of debit transactions in Australia while the international card scheme debit systems had only a relatively small share of the debit

transactions until the early to mid 2000s (Reserve Bank of Australia, 2016, p. 3). However, since 2005 the international card scheme debit systems have experienced strong growth as the four major banks added international card scheme functionality to their debit cards (Reserve Bank of Australia, 2016, p. 3). This involved switching their standard debit card products from 'proprietary' eftpos/ATM cards to DNDCs.

While eftpos essentially performed the same function as the debit cards of the international card schemes at the point of sale, the eftpos interchange fees initially flowed from the issuer to the acquirer in the opposite direction to the international scheme card debit systems (Payments System Board, 2010, p. 21). This provided quite different incentives for system participants and end users. The difference in interchange fee flows resulted in card issuers favouring the international card scheme debit systems and promoting them to customers, while merchants tended to favour eftpos (Payments System Board, 2010, p. 22).

The international card schemes also imposed honour all cards rules upon merchants (Payments System Board, 2006, p. 16). Under these rules, whenever a merchant agreed to accept credit cards issued under the Mastercard or Visa brands, it was also required to accept the scheme's debit cards as well. This meant that competitive forces could not bear directly upon the price, or acceptance by merchants of the international card schemes' debit products.

The combined impact of the flow of interchange fees and the honour all cards rules put eftpos at a competitive disadvantage in relation to the international card schemes' debit systems (Payments System Board, 2006, p. 16). While the two types of debits cards were highly substitutable for one another for domestic point of sale transactions, the international card schemes enjoyed a competitive advantage over eftpos because merchants were forced to accept the card when they made the decision to accept scheme credit cards, and the higher scheme debit interchange fees encouraged issuers to issue and promote the international card scheme debit system in preference to eftpos. In turn, the PSB (2006, p. 15) raised the possibility that, over time, the international card schemes' debit systems might displace the eftpos system entirely, not because of differences in services to merchants and cardholders, but because of the combined effect of the international card schemes' honour all cards rules and differences in interchange fees.

Following the announcement of the closure of the domestic credit card scheme Bankcard in early 2006, concerns were raised that eftpos would eventually suffer a similar fate (Cornell, 2006; Swift, 2006).

In August 2007 the Australian Bankers' Association (ABA) (2007a) declared that it and the APCA were considering establishing a commercial governance structure for eftpos that would be "responsible for the promotion and development of the EFTPOS system." The ABA (2007, p. 14) contended that:

> *Under a commercially-focussed EFTPOS governance structure, the probability of EFTPOS being revamped through features such as 'card not present' and EMV also increases, which will make the product an even stronger alternative to [international card] scheme debit and credit cards.*[2]

In April 2007 a news report suggested the RBA was concerned that eftpos "will wither as banks promote credit and debit scheme cards, which are profitable but less efficient and costly for customers" (Saulwick, 2007). This followed pressured applied by the PSB (2008, p. 10) that had previously observed:

[2] EMV is a set of specifications that define the requirements of chip-enabled cards and chip-enabled electronic data capture terminals to operate over the Europay, Mastercard and Visa networks (Blockey, 2021, p. 187). EMV stands for Europay Mastercard Visa, that were the three initial parties involved in the development of the specifications.

For many years, Australia has benefited from having a widely used, low-cost debit card system (the EFTPOS system) which, to some extent, operates in competition with the payment systems operated by the international card schemes. Looking forward, there are likely to be benefits to both consumers and merchants from continuing to be able to choose amongst a variety of different payment systems, each of which competes on price and the range of services that it offers. In this regard, the Board has been concerned that the current governance arrangements in the EFTPOS system may limit its ability to act as an effective competitor to the international card schemes. The central issue here is whether changes to these governance arrangements would promote both competition and innovation in the Australian payments system over the years ahead.

In April 2009 eftpos became a formal scheme with the establishment of eftpos Payments Australia Limited (ePAL) to govern the eftpos system. It is owned and funded by its fourteen member institutions (Payments System Board, 2010, pp. 22-23).

ePal announced a multilateral interchange fee schedule in March 2011, to take effect from October 2011 (Payments System Board, 2011, p. 14). The schedule reversed the direction of the previous bilaterally negotiated interchange fees for the bulk of eftpos transactions.

4. Least Cost Routing

DNDCs can route payment transactions through either the eftpos network, or via the networks of Mastercard or Visa debit card schemes. However, contactless transactions using DNDCs (such as 'tap and go' facility at point of sale) have been primarily processed through the generally higher-cost Visa or Mastercard networks by default, rather than through eftpos (Productivity Commission, 2018, p. 31). Merchants are likely to prefer that their financial institution routes payments through a lower-cost network by default, but most merchants are simply not given this choice.

If a customer makes a 'contact' transaction (by inserting the card and inputting a PIN) using a DNDC, the customer decides whether the transaction is routed through eftpos (if they select CHQ or SAV) or one of either MasterCard or Visa (if they select CR) (Productivity Commission, 2018, p. 491). However, if a customer makes a contactless transaction, either through a physical card or mobile wallet, they are not asked to decide which network to use.

Banks have the ability to program terminals to route contactless or tap and go payments through the eftpos or international card scheme debit systems (House of Representatives Standing Committee on Economics, 2017, p. 4). However, many merchants were prevented from routing debit card transactions through the cheaper eftpos network (Productivity Commission, 2018, p. 491). Debit transactions that are processed through the domestic eftpos system are on average less expensive than transactions processed through the Mastercard and Visa systems, reflecting both lower interchange fees and lower scheme fees (the fee that the merchant's bank pays to the payment network) (Reserve Bank of Australia, 2017, p. 36).

Least-cost routing (LCR) or merchant routing refers to merchants being given the opportunity to route contactless debit card transactions via whichever card network costs them the least to accept (Payments System Board, 2018, p. 41). According to the PSB (2018, p. 41):

Least-cost routing … is an initiative aimed at promoting competition in the debit card market and keeping downward pressure on payment costs in the economy.

While eftpos made its contactless card and terminal specifications available to eftpos members in 2012, it was not until 2017 that the tipping point in chip and contactless card issuance and terminal upgrades was reached across all banks to support rollout to enable LCR (eftpos Payments Australia Limited, 2021, p. 64).

Case Study on Contactless Payments from the Australasian Convenience & Petroleum Marketers Association

During 2017, fuel retailers reported a significant escalation in merchant fee costs and sought assistance from their industry association, the Australasian Convenience & Petroleum Marketers Association (ACAPMA) (2021, p. 3) in seeking to better understand the drivers of this increase. ACAPMA's investigations revealed that the costs had 'quietly' increased as a result of the introduction of 'tap and go' technology. Further investigations by ACAPMA revealed that debit card transaction costs had increased markedly for processing these transactions via the international card scheme gateways.

Individual investigations of the cost increases amongst a select number of retailers revealed that the cost of debit transactions increased three-fold as a result of: (a) eftpos's inability to provide a competitive offering to 'tap and go' technology at the time and (b) the opaque nature of merchant fee offerings provided by banks to retailers (Australasian Convenience & Petroleum Marketers Association, 2021, p. 3).

In January 2020, ACAPMA joined together with the Council of Small Business Organisations of Australia (COSBOA), the Australian Retailers Association (ARA), and the Master Grocers Association of Australia (MGAA) to form the Fairer Merchant Fees Alliance (2020) to advocate for greater transparency in merchant fee arrangements and the introduction of least cost routing.

As payment costs rose with the strong growth in tap and go payments, merchant groups were actively calling on acquirers to provide LCR (Reserve Bank of Australia, 2019, p. 16). According to the RBA (2019, p. 15):

> *… given that eftpos is a significantly lower-cost network on average, many merchants have expressed interest in getting access to LCR, to reverse the increase in payment costs that occurred with the shift to contactless transactions and the international schemes.*

Some merchants informed the Black Economy Taskforce (2017, p. 66) that their existing banks had indicated that they were unable or unwilling to provide LCR. In some cases merchants attributed this unwillingness to the fact that most acquirers were also card issuers and may be looking to protect the higher interchange revenues that they generated from transactions routed through the international card scheme debit systems rather than eftpos. In other cases, merchants attributed the unwillingness of banks to policies of the international card schemes that discouraged LCR. Accordingly, merchants expressed a desire for regulatory intervention to ensure the provision of LCR, that would help to hold down the cost of non-cash payments.

The Black Economy Taskforce (2017, p. 63) recommended the following in relation to LCR:

> *The RBA's Payments System Board should consider regulating to ensure downward pressure on the cost of debit card payments. In particular, where debit cards allow for the authorisation of the transaction to occur via two different networks, merchants should be given the ability to send the transaction via the lower-cost network.*

By reducing the cost of card payments, there will be an additional impetus for businesses to accept cards and move away from cash. It will also contribute to holding down business costs, which can lead to lower prices of goods and services for consumers.

The RBA should also seek to ensure that effective price competition among payment networks is maintained for dual-network debit card usage in the context of mobile wallet technology.

Following on from the deliberations of the Black Economy Taskforce, the House of Representatives Standing Committee on Economics also examined the of LCR. The House of Representatives Standing Committee on Economics (2017, pp. iii-iv) commented in relation to LCR that:

The committee is concerned by the increase in transaction costs merchants face as a result of the shift to tap-and-go payments. While the eftpos and international schemes deliver the same outcome for customers, there is a marked difference in the cost to merchants.

During the public hearings of the Committee's inquiry into Australia's four major banks, ANZ was the only bank that committed to give merchants the option to route tap and go payments through the lowest cost channel (House of Representatives Standing Committee on Economics, 2017, p. iv).

The House of Representatives Standing Committee on Economics (2017, p. 3) recommended in relation to LCR that:

The committee recommends that banks be required to give merchants the ability to send tap-and-go payments from dual-network debit cards through the channel of their choice.

Merchants should be able to choose whether to route these transactions through eftpos or another channel, noting that consumers may override this merchant preference if they choose to do so.

If the banks have not facilitated this recommendation by 1 April 2018, the Payments System Board should take regulatory action to require this to occur.

To give merchants some control over their payments system costs, in relation to LCR the Productivity Commission (2018, p. 48) recommended:

The Payments System Board should set a regulatory standard that gives merchants the ability to choose the default network to route transactions for dual-network cards. As the technology is readily available, this reform should be in force by 1 January 2019 at the latest.

During 2017-18, the PSB (2018, p. 41) responded to the slow pace of industry progress in providing LCR functionality to merchants by considering the case for regulation. Following consultation with stakeholders and commitments from the major acquirers that they would make LCR functionality available by early 2019 or sooner, the PSB decided in May 2018 that a standard was not required, but that it would reassess the case for regulation if there were further material delays to implementation.

While a few smaller acquirers began offering LCR in 2018, progress by the major banks and other acquirers was slower (Payments System Board, 2019, p. 53). All four major banks launched their LCR functionality between March and July 2019. There were some key differences in the LCR capabilities offered by acquirers, with some providing a version that enables routing based on transaction size and payment network. This allowed routing thresholds for different networks based on the

transaction value that maximises merchants' savings from LCR. By contrast, other acquirers did not give merchants this flexibility, reducing the potential cost advantages of routing. In addition, for some acquirers, LCR was not yet available on all the payment terminals they support.

Despite rejecting the recommendations of the Black Economy Taskforce, the House of Representatives Standing Committee on Economics, and the Productivity Commission to regulate for LCR, in May 2019 the PSB (2019b) welcomed the progress that has been made to date on LCR, also noting that it was expecting that the banks would promote this functionality to all their merchant customers.

However, for financial institutions there may also not be strong incentives for the continued issuance of DNDCs and the provision of LCR (Reserve Bank of Australia, 2019, p. 16). For card issuers, there may be incentives to negotiate exclusive single-network contracts with a scheme that offers higher average interchange fees and large upfront financial incentives.

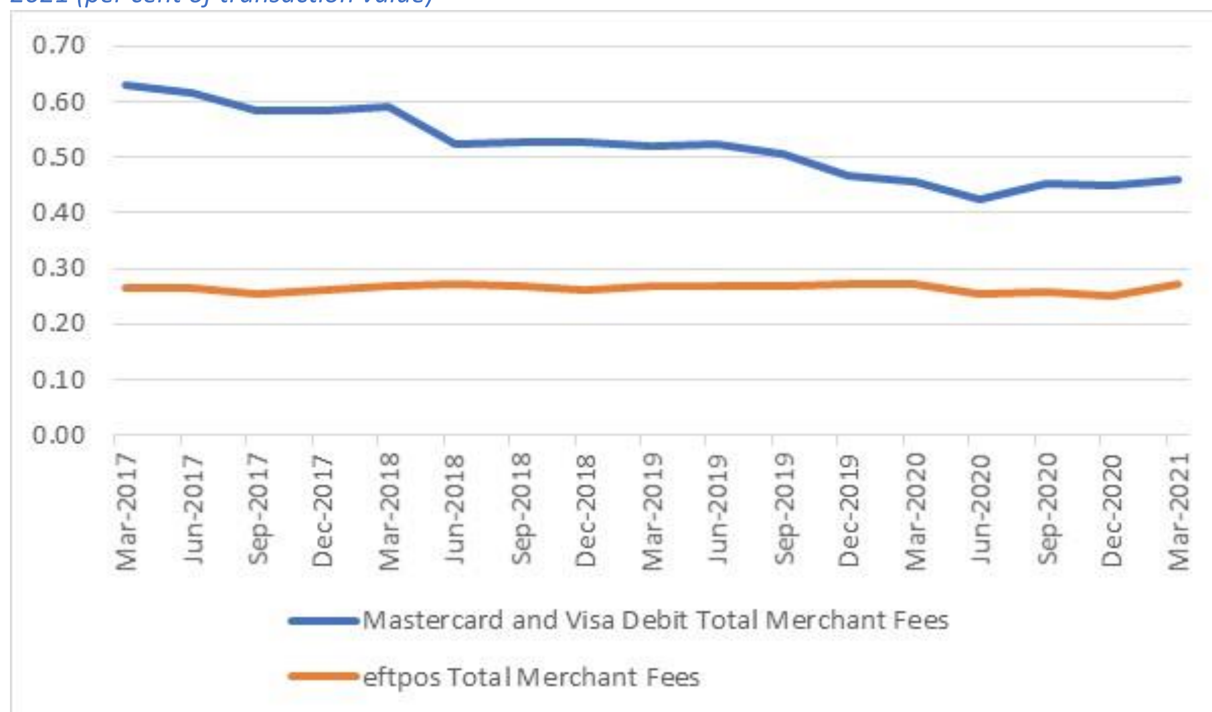
While a few smaller acquirers began offering LCR in 2018, progress by the major banks and other acquirers was slower, with the four major banks launching their LCR functionality only between March and July 2019 (Reserve Bank of Australia, 2019, p. 16).

We estimate the potential savings to small and medium sized merchants from LCR is currently around $370 million per annum for the year to the end of May 2021.[3]

The competitive tension created by LCR has seen the international card schemes reduce their total merchant service fees from an average of 0.63 per cent (of the transaction value) in the March quarter 2017 to 0.46 per cent in the March quarter 2021, as outlined in Figure 3 below.

[3] Based on RBA data series 'C2.1 Debit Cards – Original Series' to determine the value of debit card transactions acquired in Australia on domestically issued debit cards for device present. Assumed 90 per cent of debit card transaction are on DNDCs consistent with RBA (2019, p. 14). Assumed 85 per cent of debit transactions are contactless at the point of sale, a slight increase on the number as reported by Caddy, Delaney, and Fisher (2020, p. 24). Assumed 90 per cent of contactless payments made on debit cards rather than mobile wallets consistent with Caddy, Delaney, and Fisher (2020, p. 24). Assumed 83 per cent of merchants by value of transactions benefits from LCR consistent with Occhiutto (2020, p. 26). Assumed that large retailers represent 50 per cent of the value of the remaining debit card transactions acquired in Australia on domesticaally issued debit cards for device present and are already on scheme strategic rates and are thereforce excluded. Assumed the remaining merchants receive an average cost reduction of 44 basis points from LCR, slightly below the midpoint between the average gap in pricing between eftpos and the international card debit schemes of 37 basis points, and the largest gap in pricing between eftpos and the international card debit schemes of 52 basis points in 2018-19 as reported by Occhiutto (2020, p. 25).

Figure 3: Quarterly Average Debit Card Total Merchant Fees – March Quarter 2017 to March Quarter 2021 (per cent of transaction value)



Source: RBA Payments Data C3: Average Merchant Fees for Debit, Credit and Charge Cards.

The flip side of the potential savings to merchants from LCR is the potential loss of revenue for the international card schemes and card issuers. Under those circumstances, it would be understandable if there was not a lot of enthusiasm on the part of the major banks towards the rollout of LCR.

This point has recently been reiterated by the ACCC (2021, p. 10) in its consideration of the merger between eftpos, BPAY and the New Payments Platform:

> *Financial institutions may not have strong financial incentives to provide LCR.*

The ambivalence that the major banks exhibit towards eftpos has also been articulated by management consultant Lance Sinclair Blockey (2021, p. 146) in his engagements by the proposed merging entity of eftpos, BPAY and the New Payments Platform (NewCo) in the following terms:

> *This cost differential between [DNDC] and single Scheme Debit cards also reinforces the ambivalence of the card issuing businesses in major banks regarding eftpos, that is: on the one hand, they want eftpos to continue as a point of competitive leverage in their negotiations and business relationships with the international card schemes; but, on the other hand, they appreciate that profitability would be improved (at least in the short term) by eftpos disappearing and moving their portfolios to pure Scheme Debit, as this would provide more revenue, lower costs and stronger marketing support.*

The RBA's head of payments policy, Dr Tony Richards, told *The Australian Financial Review* in February 2020 that he was frustrated banks were not proactively providing merchant customers with the cheaper payments option and also warned banks against hitting customers with extra fees for using eftpos (Eyers, 2020a). According to Dr Richards:

> *One of the possible reasons for the major banks dragging their feet on least-cost routing is that they each have very extensive relationships with the large international schemes - we will be exploring this in the review.*

"What is it about this market that banks have the opportunity to send payments through whichever rails are cheapest - Eftpos in most cases - but are not choosing to do it?

Banks could be doing least-cost routing in the background for their merchant customers.

It would be simple for them to go to all smaller merchants and tell them they offer the ability to send payments on their behalf through cheaper rails. But no major bank is doing that - none of them are actively going to their smaller customers saying, 'Here is an opportunity to reduce your payments costs'. (Eyers, 2020a)

RBA Governor Philip Lowe commented at the National Press Club in Canberra in February last year in response to a question regarding what the RBA was planning to do to stop banks gouging retailers in relation to contactless payments:

We have made it very clear to the banking industry that we expect them to develop the functionality to allow the merchant to choose which payment route it goes through, the international schemes or the EFTPOS schemes, and we put quite a lot of pressure on the banks to do this. My understanding is that they've now all developed the technology solutions. And we're encouraging the merchants to actually go to their banks and say, 'turn on this functionality for me'.

So what we're doing at the moment is bringing attention to the issue, and encouraging merchants to actually ask [their] banks for the better deal.

If that process doesn't work then we would have to consider a regulatory solution. Regulating here is not the preferred option. (Poljak, 2020)

The introduction of dynamic routing for merchants would instantly calculate the least-cost route for each transaction. While eftpos is generally a lower-cost scheme on average across all merchant sizes, there is some proportion of merchants for whom this will not be the case (Richards, 2017).

A merchant might derive the most benefit from least-cost routing if transactions below a certain value are processed through Visa or Mastercard (which have percentage-based pricing), and transactions above that value are routed through eftpos (which is typically priced on a cents-per-transaction basis) (Occhiutto, 2020, p. 28). The merchant-level data suggest that Visa and Mastercard debit is materially less expensive for around 9 per cent of merchants (which account for about 5 per cent of the value of card transactions), and there is little difference between the costs of the debit networks for a further 15 per cent of merchants (Occhiutto, 2020, pp. 25-26).

There have also been a number of obstacles put in place to LCR by the international card schemes that are outlined further below.

5. eftpos Challenges

Since eftpos became a formal scheme the international card schemes in Visa and Mastercard have sought to undermine its competitive position in relation to DNDC usage.

Problems first occurred in 2010 over data-reporting rules, branding rules, and branding and transaction fees imposed by the international card schemes with respect to eftpos (Reserve Bank of Australia, 2016, p. 3). In 2011, the PSB (2011, p. 24) expressed concern about scheme rules that required commercially sensitive data on one payment system to be provided to the operator of an

alternative system, and the imposition of 'brand fees' by one payment system on a competitor's transactions.

In August 2012 the PSB identified a number of issues regarding DNDCs, including:

- scheme rules that required the provision of commercially sensitive data about one network to a competitor network
- the imposition of fees by one network on another network's transactions
- disputes over the placement of network brands on cards (Reserve Bank of Australia, 2012).

Further issues also arose between the various networks in the context of contactless debit cards (Reserve Bank of Australia, 2012). In turn, the PSB expressed concern that these developments had the potential to inhibit competition, limit choice to consumers, and increase costs.

In August 2013 the PSB announced that the international card debit schemes and eftpos had agreed to address the Board's concerns through:

- where an issuer wishes to include applications from both networks on the same card and chip, the networks agreed to work constructively with the issuer to allow this
- not to prevent merchants from exercising choice in the networks they accept, in both the contact and contactless environment
- agreement not to prevent merchants from exercising their own routing priorities when there are two contactless debit applications on the same card (Reserve Bank of Australia, 2013).

However, Tyro (2017, pp. 1-2) has asserted the international card schemes were able to circumvent these undertakings through influencing the issuers to block merchant choice:

> *… the Visa and MasterCard schemes have mandated to the issuers that their own network has to be the first priority in network selection. When a cardholder selects his/her dual network, contactless card for a transaction, the eftpos terminal automatically routes the transaction to the application with the highest priority on the contactless card's chip. The consequence is that for the high volume of contactless transactions, any choice for the merchant or the consumer is de facto removed. The technical specifications are written in a way that makes it impossible for the acquirer to offer its merchants a possibility to overwrite the mandated network priority. Merchants have been precluded from network choice or low cost routing for these contactless transactions.*
>
> *…*
>
> *Merchants are de facto prevented from any choice in the contactless environment. Theoretically, they could decide to accept only eftpos, yet given the preponderance of the global schemes, that is not an option. Thus, through the priority mandated, the global schemes enforce that contactless transactions are automatically routed via their network.*

In response to Tyro claims, the Productivity Commission (2018, p. 492) opined that:

> *Such decisions appear to demonstrate substantial market power on the part of the card schemes and financial institutions. This behaviour could be expected when the card schemes and card issuers receive higher revenue per transaction if they are processed through Visa and Mastercard, rather than eftpos. For example, a financial institution that is both a card issuer and merchant acquirer may prevent its acquiring arm from offering merchant choice routing if there is an overall gain to the institution from using the higher-cost network.*

In 2016 there were reports of conduct that had sought to prevent or deter Australian issuers of DNDCs from provisioning those cards to enable eftpos mobile payments (Reserve Bank of Australia, 2016, p. 8). Concerns were raised regarding two types of actions:

- Scheme rules or policies of a network that prevent or hinder Australian card issuers from provisioning a competitor network for mobile payments (either expressly or through policies or restrictions that achieve that outcome in practice). In particular, concerns were raised that issuers with existing dual-network cards might be prevented from enabling both networks on those cards for mobile payments.

- Contractual terms for tokenisation services that could penalise an Australian issuer for provisioning a competitor network for mobile payments. In particular, concerns were raised that contractual terms may allow a scheme to increase the price of tokenisation services for issuers that choose to also enable a network other than that scheme.

The PSB (2017) observed that such restrictions could have the effect of reducing competition and efficiency in the payments system. However, the PSB (2017) announced in May 2017 that it had received commitments from relevant participants that addressed these concerns:

> *These commitments, which will be shared with industry participants, should facilitate greater choice and convenience in the payment options available to cardholders through mobile devices and improve the ability of merchants to encourage the use of lower-cost payment methods. Given this outcome, the Board does not see a need for regulation at this point.*

In early 2018, the RBA (2021, p. 11) sought and received assurances from the international card schemes that they would not respond to LCR in ways that would limit the competitive pressure in the debit card market – such as linking strategic interchange rates on credit card transactions to the value or volume of merchants' debit card transactions or their decision to adopt LCR.

In its review of retail payments regulation issues paper released in December 2019, the RBA (2019, p. 16) expressed concern there are several factors that may be limiting the overall downward pressure on merchant payment costs arising from the implementation of LCR:

1. lower interchange rates for some debit card transactions have been accompanied by increases in rates on other types of cards and/or transactions, in some cases for segments of the market where LCR is not an option
2. the RBA has continued to hear concerns that merchants may lose access to favourable strategic rates on credit transactions if they adopt LCR for debit transactions
3. there appears to have been only limited competitive response in the form of lower scheme fees, which also affect payment costs to merchants and where the international schemes appear to remain more expensive than eftpos.

The PSB (2020, p. 48) observed in its most recent annual report that while the competitive pressure associated with LCR appears to have resulted in lower interchange rates for some merchants, particularly larger ones, there is some evidence that this has been accompanied by increases in rates on some other types of debit transactions, including where LCR is not an option. The PSB (2020, pp. 48-49) also reported that the RBA had heard concerns from some merchants that they may be penalised by higher interchange rates on their credit transactions if they adopted LCR for debit transactions.

In March 2021 the ACCC (2021a) accepted a court-enforceable undertaking from Visa under section 87B of the *Competition and Consumer Act 2010* in relation to concerns that Visa may have limited competition in relation to debit card acceptance through its dealings with large merchants. The ACCC expressed concern that Visa's strong market position in the credit card acceptance market

could be leveraged to limit competition in the debit card acceptance market by tying the offer of cheaper strategic merchant rates for credit card transactions to a commitment from the merchant to process Visa branded dual network debit card transactions via the Visa network and not through eftpos. The ACCC was concerned that Visa's dealings with merchants could influence their choice of debit card network, and diminish competition between Visa and eftpos in relation to debit card acceptance. The Visa undertaking means that it cannot offer strategic merchant rates for credit card payments to merchants on condition that the merchant processes debit card payments through the Visa network.

6. eftpos Market Position

According to the PSB (2020, p. 29) in its most recent annual report:

> *The debit and credit card markets in Australia are dominated by two international card schemes, Visa and Mastercard. In the debit card market, the share of transactions made using these two schemes has been increasing for much of the past decade, while the share of the domestic debit scheme, eftpos, has been declining. The decline in eftpos' market share can partly be attributed to the increasing use of contactless payments, given that the international schemes are the default networks on dual-network debit cards. In addition, the eftpos network only recently began supporting some online and other remote transactions, which have been making up an increasing share of card payments (particularly during the COVID-19 pandemic). However, the take-up of least-cost routing functionality by some merchants over the past year or so has slowed the decline of eftpos' market share … .*

The adoption of LCR by a large number of merchants has provided a recent lift in transaction volume for eftpos (Blockey, 2021). In 2019-20 eftpos transaction volumes increased by 17.7 per cent on the prior year prior to the impact of the COVID-19 pandemic that reduced the end position to a net 13.3 per cent growth on prior year (eftpos Payments Australia Limited, 2020, p. 3). This halted the previous trends of declining volume and market share experienced by eftpos across several years.

However, the share of international card schemes (Mastercard and Visa) has been steadily increasing over time in line with the growth of the overall debit market (eftpos Payments Australia Limited, 2021, p. 19). The rising market share of the international card schemes can be partly attributed to the increasing use of contactless payments, which were only supported by the international debit schemes until eftpos introduced the capability (Payments System Board, 2019, p. 26).

As transactions migrated from PIN entry to contactless or 'tap and go', there was an increase in fees merchants' paid to their banks, reflecting a shift in the routing of debit card transactions from the domestic eftpos network to the higher-cost Mastercard and Visa debit card networks (Black Economy Taskforce, 2017, p. 63). eftpos volumes experienced a steep decline from 2016 to 2019 due to the international card schemes being the default rails for contactless payments in-store (Edwards, 2021, p. 28).

While eftpos made the specifications for contactless technology available in 2012-13, its implementation by eftpos members took a long time (eftpos Payments Australia Limited, 2021, p. 19). Before this capability was introduced, all contactless payments were processed on the Visa / Mastercard system. eftpos only achieved greater than 75 per cent coverage of contactless capability in 2017. Even though eftpos has now implemented its contactless capability, contactless payments still default to the Visa / Mastercard payments system on DNDCs (Payments System Board, 2020, p. 29).

The Productivity Commission (2018, p. 470) observed that while eftpos was highly price-competitive, recent declines in its market share were concerning and could be attributed to the fact that competition had been stymied by other forces, such as distortions in who pays the costs of card payments.

Several smaller and mid-sized issuers have begun moving away from DNDCs towards single-network debit cards (SNDCs) which allow payments to be processed through only one of the international debit card scheme networks (Reserve Bank of Australia, 2021, p. 9). According to the RBA (2021, p. 9), the switch towards SNDCs reflects two factors. First, the international schemes have been keen to facilitate the issuance of these cards for some time and at least one scheme is offering higher interchange rates on transactions on SNDCs. Second, the additional cost of issuing debit cards with two networks instead of one.

The additional cost of supporting two debit systems, eftpos and the international card schemes', on the same card has seen most of the new digital banking entrants to Australia decide to issue SNDCs instead, with all of these choosing to issue either Visa debit or Mastercard debit card in order to provide a full range of functionality (including cross-border payments) to their mainly younger customers (Blockey, 2021, p. 146).

The additional cost of supporting DNDCs is not just a cost issue for the digital bank entrants, but also for existing issuers, especially those with smaller portfolios of debit cards (e.g. second tier banks, credit unions and building societies) (Blockey, 2021, p. 146). Indeed, towards the end of 2020, Macquarie Bank re-issued single scheme Mastercard debit cards to all of their transaction account holders, and stopped supporting eftpos debit transactions (Blockey, 2021, p. 146n). According to Dr Geoff Edwards (2021, p. 79n), the economic expert engaged by NewCo:

> *I understand that some financial institutions only issue single network debit cards and that this may become more common in the future.*

According to the McLean Roche Consulting Group (2021, p. 26):

> *Banks and Credit Unions who co-own eftpos have preferred to trash their investment in eftpos to issue Visa and MasterCard debit cards which charge much higher merchant fees for exactly the same service in Australia.*

Furthermore, the future viability of eftpos could be put in jeopardy by the targeted use of strategic merchant rates by the international card debit schemes. When larger merchants adopt LCR and their DNDC transactions are routed via eftpos, they lose access to strategic interchange rates on other debit card transactions that continue to be processed through the international card scheme networks; the latter transactions would include transactions on DNDCs where the customer actively selects the international network or where routing is not possible because they are online or due to some problem with the chip or the issuer as well as transactions on SNDCs (Reserve Bank of Australia, 2021, p. 10). This risks reducing the benefits and undermining the attractiveness of LCR for large merchants and in turn reducing the capacity of eftpos to compete for the business of smaller merchants, as outlined by the RBA (2021, p. 10):

> *An increase in the prevalence of (international scheme) SNDCs would increase the pool of non-routable transactions that must be processed through the international schemes, while decreasing the pool of routable DNDC transactions. This would raise the cost of losing strategic interchange rates – lowering the savings from LCR – to the point where LCR might not be commercially attractive for large merchants. Stakeholders have suggested that with the ongoing shift towards mobile payments, which is separately increasing the pool of non-routable transactions processed through the international schemes … , the financial case for large merchants to adopt LCR is already becoming marginal.*

In a world with more SNDCs, smaller merchants, which do not have access to strategic rates, might continue to benefit from LCR. However, if eftpos cannot compete for the volume of large merchants, its ability to compete for smaller merchants would also be weakened.

When card issuers have introduced new functionality – such as enabling Apple Pay for cardholders – they have often done so first for the international card schemes, with no firm plans for also enabling eftpos (Reserve Bank of Australia, 2019, p. 16). This in turn raises the prospect that LCR can be "neutralised" through the growing prevalence of mobile wallets (Blockey, 2021, p. 147).

Reflecting on the position of eftpos back in 2019, ePAL (2021, p. 45) has recently reflected:

… it was clear that the core eftpos business carried significant risks due to low and slow member support (issuing and acquiring), a continued decline in the proprietary book, slow and unreliable regulatory intervention and slow uptake of least cost routing. We were also a slow follower historically, driven largely by members and somewhat by eftpos and our pricing and rebate approach was not aligned with our competitors resulting in the inability to fund developments by our members. eftpos interchange was also materially lower than its competitors.

As of 2020, eftpos's historical, core retail payment card business still remains in "catch-up mode", and, without pressure (but not regulation) being applied by the RBA to merchant acquiring institutions to adopt LCR and without a diversification strategy, transaction volumes would likely still be in absolute decline (Blockey, 2021, pp. 144-145). However, eftpos has largely completed its catch-up with the international card schemes on core capabilities (eftpos Payments Australia Limited, 2021, p. 47). It is also diversifying into digital wallets through its 'Beem It' subsidiary, developing a digital identity service (connectID), as well as developing a market wide scalable QR code acceptance network supporting digital wallet retail payments across instore, self-service and online channels (eftpos Payments Australia Limited, 2021). These initiative all provide points of differentiation between eftpos and the international card schemes.

The use of tokenisation for recurring payments, particularly in online transactions where eftpos is only just entering the market, may be problematic for eftpos given that tokenisation of stored card details is well underway by the international card schemes (Blockey, 2021, p. 147). Tokenisation allows merchant systems to hold payment details as a random 16 digit number rather than the real card number (primary account number or PAN). When card numbers are tokenised with a merchant, it helps reduce fraud by devaluing any card details obtained by a hacking or cyber security event because a token can only be decrypted to the real PAN by the token vault provider that created the token, so if the token is created by Visa, for example, only Visa can use it to make a payment. With scheme tokenisation, if a card is lost or expired, the token can remain valid, whereas the old PAN will not work. This is attractive for merchants and consumers because tokenisation reduces instances of failed payments due to lost, stolen and expired cards, and saves the consumer and merchant from re-entering new card details.

As coverage of scheme tokenisation increases, the scope for eftpos card on file to compete for recurring payments will be reduced due to the developing inventory of tokens held by merchants (Blockey, 2021, p. 147). eftpos would need to persuade merchants to go to the trouble of asking either the gateway to re-tokenise the PAN into eftpos, or the cardholder to re-enter the card details and then choose eftpos tokenisation rather than scheme tokenisation – potentially introducing friction to the merchant/consumer relationship. eftpos has had tokenisation capability since 2016-17 and as part of its online enablement has been working with acquirers, gateways and merchants to also tokenise cards, although progress has been slow in having members agree to implement this capability for eftpos.

Management consultant Lance Sinclair Blockey, who was engaged as the industry expert by NewCo, has warned the future for eftpos is bleak without some sort of regulatory intervention:

> *Judging by the past actions of Visa and Mastercard when presented with competitive pressure, the current growth in eftpos transaction volume occurring due to Merchant Choice Routing is likely to be short lived, as the international schemes will react to maintain (and eventually grow) their share in debit transactions. By changing scheme fees (the key income stream for eftpos) and interchange rates (including the targeted use of Strategic Merchant Rates), Visa and Mastercard will endeavour to lower their costs on the relevant debit transactions for merchants, in order to ensure that their schemes are least cost and not eftpos. (Blockey, 2021, pp. 146-147)*
>
> *So, without some change of structure or highly proactive intervention by the RBA, in my opinion it is likely that within the next 10 years the core eftpos debit card business at EPAL will disappear, and that Visa and Mastercard … will dominate point of sale card-based transactions in Australia, even more than they do today - probably by ensuring that they are the low cost option. (Blockey, 2021, p. 148)*

Similarly, one of the two counterfactuals for eftpos' future outlined by Dr Geoff Edwards (2021, p. 27), the economic expert engaged by NewCo, was also for its demise:

> *The second counterfactual I consider to be likely, in the sense of having a real chance of occurring, is one in which the eftpos card-based payment system will cease to operate within ten years unless there is proactive intervention by the RBA to maintain a domestic card-based payment infrastructure.*
>
> *In this counterfactual, eftpos may encounter renewed competition from the [international card schemes] for in-store volumes and fail to successfully transition to online payments or find ways to differentiate its offerings sufficiently from the offerings of the [international card schemes]. With volumes then declining rapidly – as they did from 2016 to 2019 – eftpos may find financial institutions and the RBA unwilling or unable to justify continuing to support it.*

7. Domestic Debit Schemes

7.1 International Experience

As is the case in relation to eftpos, domestic debit card schemes around the world are feeling increasingly strong competitive pressure from Visa and Mastercard, who continue to encourage issuing banks to move to their debit card schemes in order both to provide increased functionality to their customers (e.g. contactless cards, cross-border and online payments, fraud management, and consumer marketing promotions) and to gain the benefits of the international schemes' (e.g. higher revenues [on both domestic and cross-border transactions] marketing and product development support, and access to tokenisation and fraud services) (Blockey, 2021, p. 141).

Within the European Union (EU), some Member States' national payment schemes – with lower fees – have been abolished and replaced by the international card schemes offering higher fees to issuing banks than the domestic payment card scheme (European Commission, 2013, p. 29). In August 2002, the 19 United Kingdom (UK) banks that jointly owned the Switch domestic debit card scheme reached a licensing agreement with Mastercard Europe that would see all Switch cards rebranded to the Mastercard-owned Maestro brand (Fisher N. , 2002).

Through the implementation of Single Euro Payments Area (SEPA) technical standards, there was a trend for national (low fee) card schemes to be abolished; in a number of EU Member States banking

communities chose not to invest in the domestic payment card scheme to comply with SEPA technical standards (European Commission, 2013a, p. 152). In this regard, the European Commission (European Commission, 2013a, p. 152) observed:

> *In this situation banks move to issuing cards of the two existing international payment card schemes, Visa and MasterCard, that offer higher fees to issuing banks than the domestic payment card scheme. …*
>
> *Any payment solution offering lower profit opportunities will be seen by banks as less interesting to implement from the commercial perspective.*

As a consequence, many European domestic card schemes were abandoned in the last decade: Luxembourg's bancomat in 2011; the Netherlands' PIN in 2012; Finland's pankkikortti in 2013; and Ireland's Laser in 2014 (Meyers, 2021, p. 2). In European countries where domestic card schemes remain, the international card schemes tend to have only a marginal market share (Veljan, 2020, p. 146). This is because the domestic card schemes receive strong support from their scheme-owning banks that generally market the domestic card schemes in preference to the competing international card schemes.

Most of the remaining domestic debit card schemes around the world have been supported by the active intervention of their local regulator(s) or government authorities (Blockey, 2021, pp. 143-144). Although taking a rather different perspective on the matter, Visa (2020, p. 22) has observed in relation to domestic card networks:

> *Governments in a number of jurisdictions shield domestic payment card networks, brands, and processors from international competition by imposing market access barriers and preferential domestic regulations. To varying degrees, these policies and regulations affect the terms of competition in the marketplace and undermine the competitiveness of international payments networks. Public authorities may impose regulatory requirements that favour domestic providers or mandate that domestic payments or data processing be performed entirely within that country, which could prevent us from managing the end-to-end processing of certain transactions.*

Similarly, Mastercard (2021, p. 18) has complained:

> *Some governments have taken action to provide resources, preferential treatment or other protection to selected domestic payments and processing providers, as well as to create their own national providers. For example, governments in some countries mandate switching of domestic payments either entirely in that country or by only domestic companies.*

Regulatory intervention generally takes one of two paths: (i) creating a level playing field; or (ii) actively promoting and favouring the domestic card scheme over the international card schemes. Regulation can promote a level playing field through the adoption of an activity-based approach, as opposed to an entity-based one (Restoy, 2021, p. 2). This requires imposing similar requirements upon all active players in a particular market segment.

In the United States (US), the Durbin Amendment prohibits all issuers and networks from: restricting the number of networks over which electronic debit transactions may be processed to less than two unaffiliated networks; and inhibiting a merchant's ability to direct the routing of the electronic debit transaction over any network that the issuer has enabled to process them (Reserve Bank of Australia, 2021, p. 12n).

In the EU from June 2016, consumers and retailers can choose the payment type when paying with co-badged cards (Productivity Commission, 2018, p. 491). Retailers can install a default application choice in their payment terminals but must inform customers who have the last say and can override with their own preference. The EU regulations state that the routing of transactions through a specific channels or process, with respect to the handling to two or more co-badged applications, shall be non-discriminatory.

Further details of regulatory interventions in the United States and the European Union are outlined in Appendix I below.

In Malaysia merchants can steer cardholders to use cost-effective payment cards in relation to co-badged debit cards and have the first priority in routing decisions (Leong, 2018, p. 7).

One country that has shifted from an entity-based to an activity-based approach to regulation is Norway.[4] BankAxept is the domestic debit card scheme in Norway and its zero interchange fee model has enabled it gain widespread merchant acceptance. The most widely used payment card in Norway is a co-badged BankAxept card with either the Visa or Mastercard debit scheme (Norges Bank, 2021, p. 9). BankAxept cards are primarily used for payments at physical points of sale within Norway, but cannot be used for online or overseas payments (Norges Bank, 2021, p. 10). While international payment cards can also be used for payments at physical points of sale within Norway, they are mainly used for online and overseas payments. A "prioritization rule" that previously operated meant that BankAxept was automatically chosen for payments with co-badged cards to Norwegian merchants unless the customer requested otherwise (Norges Bank, 2016, p. 10). However, new regulations brought in to align Norway with the June 2016 EU regulations abolished the "prioritisation rule", but still permitted merchants to choose a preferred network to process co-badged card payments (BankAxept, 2016).

Other countries have taken an entity-based approach to regulation through actively promoting domestic payment card systems.

In March 2002 UnionPay was established as China's first and only bankcard association on the approval of the State Council of China and China's central bank with the first UnionPay card being launched in August 2003 (Yip & Yao, 2015). Until recently, UnionPay has essentially operated as a monopoly in China in the provision of ATM cards, debit cards, credit cards, and prepaid cards. It was only in June 2016 that China announced that it was opening its domestic bank card market up to competition (Mak, 2016). Up until 2016, Chinese banks together with UnionPay had been permitted to issue dual brand cards with Visa or Mastercard, but with the international schemes only being involved in transactions occurring outside of China (Blockey, 2021, p. 144). However, Chinese banks subsequently halted all orders for co-branded bank cards bearing the logos of foreign card issuers such as Visa and MasterCard following a notice from the People's Bank of China that directed them not to renew the cards (Weinland, 2016). Since its establishment, UnionPay has become a major international card payments scheme in its own right.

In 2009 the Reserve Bank of India (RBI) announced its intention to launch a domestic payment card network (Bhattad, Tole, & Choudhary, 2011, p. 10). As a part of this initiative, the RBI helped create the National Payment Corporation of India (NPCI), an organisation that oversaw the launch of domestic payment cards called RuPay (Bhattad, Tole, & Choudhary, 2011, p. 10), the name being a portmanteau of "rupee" and "payment" and has been heavily promoted by the Indian Government (Nandi, 2019). The RBI previously instituted a rule that forced every bank to carry two network marks on all Indian issued credit and debit cards – one of which must be RuPay (The Economic

[4] While not a member of the EU, under the European Economic Area agreement Norway is granted access to the EU's single market provided the same rules and conditions of competition applying in the EU are also applied in Norway.

Times, 2019). However, in November last year in an address to the Annual General Meeting of the Indian Banks' Association, Indian Finance Minister Nirmala Sitharaman commented:

> *Whenever issuing a card, you must first issue a Rupay card (Roy, 2020).*

Following the nudge by the Indian Government to favour India's domestic card network, state-owned banks stopped issuing non-RuPay debit cards unless specifically requested (Ghosh & Pathak, 2021).

In order to promote the development of retail payment systems, in 2010 the Central Bank of Brazil conducted an in-depth analysis of the status quo, and then issued reports and directives to address inefficiencies identified in the payments market (Committee on Payment and Settlement Systems, 2012, p. 81). One report found that the credit and debit card schemes affiliated with Visa and Mastercard possessed "significant market power" (Central Bank of Brazil, Secretariat for Economic Monitoring – Ministry of Finance, & Secretariat of Economic Law – Ministry of Justice, 2010, p. 9). It was also found that:

> *There is evidence that the existence of a local debit card arrangement is somewhat important to keep contestability alive in this market. (Central Bank of Brazil, Secretariat for Economic Monitoring – Ministry of Finance, & Secretariat of Economic Law – Ministry of Justice, 2010, p. 9)*

In response, in 2011 the state-controlled institutions Banco do Brasil SA and Caixa Econômica Federal, and the privately-controlled Banco Bradesco, launched Elo, a new domestic debit card scheme for Brazil (Grover, 2016). Elo is now one of the biggest players in the retail payments sector in Brazil – a major domestic debit and credit card brand with over 132 million cards accepted by 10 million merchants in the country (The Paypers, 2020).

In Canada competing domestic debit card schemes cannot be co-badged on the same card (Australian Payments Clearing Association, 2017). However, complementary applications can be co-badged and equally branded, with the domestic debit scheme favoured for domestic point of sale transactions and Visa favoured for card not present and cross-border transactions.

7.2 Why Domestic Card Schemes Can Struggle to Survive

Domestic card schemes can become dominant where an entity-based approach to regulation is adopted that seeks to actively promote the domestic payment card system. As is the case in Europe, domestic card schemes can also thrive and prosper where an activity-based approach is taken to regulation while also enjoying active support from their scheme-owning banks.

However, domestic card schemes can sometimes struggle to survive even where an activity-based approach is taken to regulation that seeks to create a level playing field. Support from scheme-owning banks for domestic card schemes can be undermined through international card schemes incentivising card issuers with higher interchange fees as has happened in parts of Europe. Another reason as to why domestic card schemes can sometimes struggle to survive is contained in recent documents published by Visa and Mastercard outlined below.

Visa (2020, p. 25) notes that it is involved in numerous litigation matters, investigations, and proceedings asserted by civil litigants, governments, and enforcement bodies alleging, among other things, violations of competition and antitrust law.[5] Amongst the investigations and litigations Visa (2020, pp. 119-120) has recently been subjected to, are the following:

[5] US competition law is referred to as antitrust law. The term antitrust has its origins in combating the effects of trusts – combinations by which businesses prevented competition among themselves (Barnes, 1999, p. 115).

- On March 13, 2012, the Antitrust Division of the US Department of Justice issued a Civil Investigative Demand, or "CID," to Visa Inc. seeking documents and information regarding a potential violation of Section 1 or 2 of the Sherman Act. The CID focuses on PIN-Authenticated Visa Debit and Visa's competitive responses to the Dodd-Frank Act, including Visa's fixed acquirer network fee.
- On November 25, 2014, Pulse Network LLC filed suit against Visa Inc. in the United States federal district court in Texas alleging that Visa has, among other things, monopolised and attempted to monopolise debit card network services markets.
- On November 4, 2019, the Bureau of Competition of the US Federal Trade Commission (the "Bureau") requested that Visa provide, on a voluntary basis, documents and information for an investigation as to whether Visa's actions inhibited merchant choice in the selection of debit payments networks in potential violation of the Durbin Amendment. On June 9, 2020, the Federal Trade Commission issued a Civil Investigative Demand to Visa requesting additional documents and information.
- On June 26, 2020, the European Commission ("EC") informed Visa that it has opened a preliminary investigation into Visa's rules regarding staged digital wallets and issued a request for information regarding such rules.

Further, in March this year, Visa (2021) announced in a regulatory filing that the US Department of Justice had informed it of its plans to open an investigation into Visa's US debit practices and Visa had received a notice to preserve relevant documents related to the investigation. According to news reports, the antitrust division of the US Department of Justice has been gathering information and asking whether Visa has limited merchants' ability to route debit-card transactions over card networks that are often less expensive (Andriotis & Kendall, 2021). Many of the department's questions have focused on online debit card transactions, but investigators have asked about in-store issues as well.

Similarly, Mastercard (2021, p. 23) also notes it is a defendant in a number of civil litigations and regulatory proceedings and investigations, including among others, those alleging violations of competition and antitrust law.

A discussion of relevant competition/antitrust economic and legal issues is provided below.

8. Competition and Antitrust

8.1 Exclusionary Conduct

Monopoly, also often referred to as market power, is the power to raise or maintain prices above, and restrict output below, the competitive level (Salop & Romaine, 1999, p. 619).

Exclusionary conduct has been defined as acts that:

1) are reasonably capable of creating, enlarging or prolonging monopoly power by impairing the opportunities of rivals
2) that either (2a) do not benefit consumers at all, or (2b) are unnecessary for the particular consumer benefits that the acts produce, or (2c) produce harms disproportionate to the resulting benefits (Areeda & Hovenkamp, 2002, p. 72).

Exclusion involves a firm (or group of firms) raising the costs or reducing the revenues of competitors in order to induce the competitors to raise their prices, reduce output, or exit from the market (Salop, 2006, p. 311). It generally involves a firm with market power investing some of its profits in making it unprofitable for other sellers to compete with it, thus perpetuating its market power (Posner, 2001, pp. 40-41). Exclusionary conduct generally covers two types of conduct:

- predatory pricing
- raising rivals' costs (RRC) (Salop S. C., 2017, p. 374).

In the simplest rendition, predatory pricing involves an across-the-board reduction in prices intended to permit a deep-pocket firm to win a war of attrition against a less well-financed entrant or small competitor (Salop S. C., 2017, pp. 374-375).

The reduction in prices during the predatory phase of a predatory pricing strategy involves short-term profit-sacrifice or actual losses by the predator (Salop S. C., 2017, p. 375). Controversy surrounds whether predatory pricing will be followed by a period of recoupment – high prices to recover the losses experienced during the course of predatory pricing.

RRC foreclosure generally describes exclusionary conduct that totally or partially "forecloses" competitors from access either to critical inputs or customers, with the effect of causing them to raise their prices or reduce their output, thereby allowing the excluding firm to profit by setting a supracompetitive output price, with the effect of harming consumers (Salop S. C., 2017, p. 376).

Input foreclosure raises costs for entrants' or existing rivals' by materially raising their costs or eliminating their efficient access to critical inputs (Salop S. C., 2017, p. 384).

Customer foreclosure refers to using exclusive contracts and other strategies that exclude rivals from access to a sufficient customer base (Salop & Romaine, 1999, p. 627). If the monopolist can reduce the sales of a competitor through the use of exclusive contracts, bundling, or other means, the rival may suffer higher costs that make it a less formidable competitor in selling to other customers. The competitor may even be forced to exit. In turn, customer foreclosure focuses on the impact of losing efficient access to customers (Salop S. C., 2017, p. 386).

While input foreclosure strategies are commonly thought of as raising rivals' costs while customer foreclosure strategies are commonly thought of as limiting rivals' access to the market, customer foreclosure strategies can also be understood as another form of raising rivals' costs because they raise rivals' costs of distribution (Baker, 2013, p. 538n).

8.2 Parallel Exclusion

Parallel exclusion is self-entrenching conduct, engaged in by multiple firms, that harms competition by limiting the competitive prospects of an existing or potential rival to the excluding firms (Hemphill & Wu, 2013, p. 1189). Parallel exclusion seeks to block or slow would-be market entrants (Hemphill & Wu, 2013, p. 1185). Parallel exclusion is pervasive in industries that comprise a few major players. Parallel exclusion has also been referred to as multilateral exclusion (Hovenkamp, 2005, pp. 163-164).

Case Study on Parallel Exclusion

In the United States Visa and Mastercard were the first firms to offer general-purpose credit cards issued by banks, beginning in the 1960s (Hemphill & Wu, 2013, p. 1191). By the 1980s, the two companies had come to completely dominate the bank-issued credit card industry, and most American banks issued both cards and virtually every retailer accepted both cards (Hemphill & Wu, 2013, pp. 1191-1192).

In the late 1980s and 1990s, various firms attempted to enter the lucrative market for credit cards, including Discover and American Express (Amex), the latter of which had until then traditionally issued its own charge cards under a different business model (Hemphill & Wu, 2013, p. 1192). Matters came to a head when American Express began to recruit banks to issue a new line of Amex-branded credit cards. To prevent the arrival of another competitor in the credit card market, Visa and, later, MasterCard adopted similar exclusionary rules. The rules banned any member banks from issuing Amex or other cards, on pain of losing the right to issue cards from Visa and MasterCard. With the rules in place, a bank would have to completely forgo issuing Visa and Mastercard cards if it wanted to deal with American Express.

Visa and MasterCard both promulgated rules that forbade member banks who issued credit cards from issuing any credit cards other than Mastercard or Visa, on threat of losing membership in the respective networks (Hemphill & Wu, 2013, p. 1202). The networks essentially used the banks as their agents to exclude American Express from the market for bank-issued credit cards. The threat of being cut off from the Visa or MasterCard network kept each bank in line.

In 1998 the US Department of Justice launched a suit against Visa and Mastercard alleging that their exclusionary rules violated section 1 of the Sherman Act.

In September 2003 the United States Court of Appeals for the Second Circuit affirmed a district court ruling invalidating Visa and Mastercard rules that prohibited member banks from issuing American Express or Discover (Kolasky, et al., 2003).[1] The district court had found that these exclusionary rules substantially harmed competition and failed scrutiny under a rule of reason analysis.

1. *U.S. v. Visa U.S.A., Inc.*, 2003 WL 22138519 (2d Cir. Sept. 17, 2003).

Effective, anti-competitive parallel exclusion generates several distinct harms (Hemphill & Wu, 2013, p. 1210). Parallel exclusion allows the excluders to sustain higher prices. This results in an inefficient level of output produced because some of the consumers who would have purchased the product in a competitive market do not choose to do so at the higher price, resulting in a loss of allocative efficiency. The additional harms of parallel exclusion come from slowing or blocking product innovation of two types: the introduction of *higher-quality* substitutes and *lower-cost* substitutes.

Professor Herbert Hovenkamp (2005, pp. 163-164) of the University of Pennsylvania has suggested that the test for multilateral exclusionary conduct by firms enjoying collective market power need inquire only whether the conduct impairs the opportunity of rivals without significantly reducing the perpetrators’ costs or improving the quality of their product.

8.3 Tying and Bundling

Tying refers to conditioning the sale of one good on the purchase of another (Church & Ware, 2000, p. 168). Tying of two products (or services) occurs when a seller sells one good (tying good) on the condition that the buyer buys the other good (tied good) from that seller or imposes on the buyer the requirement that they will not purchase the other good from another seller (Economides, 2018, p. 141).

Bundling is a general term describing selling collections of goods as a package (Economides, 2018, p. 141). Bundling is the practice of selling two (or more) products together; the products may be available only as a bundle or, if available separately, are offered at a discount relative to their individual prices (Nalebuff, 2003, p. 9).

Pure bundling is the simplest case of a bundle; in a pure bundle, two goods, A and B, are only sold together and are not available for individual purchase (Nalebuff, 2003, p. 13). Furthermore, in a pure bundle, the goods A and B are offered only in some fixed proportion, such as one steering wheel and four tyres as part of a motor vehicle.

With mixed bundling goods A and B are sold as an A-B package as well as being sold individually (Nalebuff, 2003, p. 14). However, with a mixed bundle the package is sold at a discount to the individual components. Essentially, mixed bundling is the conditioning of discounts in one market on the purchase of products or services in another market (Crane, 2006, p. 423).

Tying is a special case of bundling in which consumers do not have the choice of buying the “tied” product without the “tying” product (Evans & Salinger, 2005, p. 41).

Bundling is pervasive throughout the economy and there are many products that can only be bought as a bundle (Gans & King, 2002, p. 3). For example, shoes are sold in pairs as almost everyone who wants a right shoe also wants a matching left shoe as well and bundling the two together makes sense (Salinger, 1995, p. 85). However, bundling has also occurred in situations where the products concerned are unrelated to one another, such as bundling fuel discounts with grocery shopping.

For the vast majority of cases where bundling is observed, the reason why separate goods are sold as a package can be explained by economies of scope in production or by reductions in transaction and information costs, with an obvious benefit to the seller, the buyer or both (Kobayashi, 2005). This is the presumptive explanation for bundling when it occurs in highly competitive markets. Because they involve lower prices, bundled discounts and bundled rebates typically benefit consumers (Antitrust Modernization Commission, 2007, p. 94).

However, bundling can have ambiguous economic consequences (Gans & King, 2002, p. 2). In markets characterised as oligopolistic, bundling may have strategic uses that may warrant scrutiny under competition law (Kobayashi, 2005, p. 708).

There is increasing recognition that bundling can result in adverse effects when practiced by dominant firms. According to the European Commission (2005, p. 54), bundling can result in anti-competitive effects due to foreclosure, price discrimination and higher prices. According to the US Antitrust Modernization Commission (2007, pp. 95-96):

> *… recent economic literature has suggested three theories by which, in certain circumstances, bundled discounts could be unreasonably exclusionary: (1) as a form of predatory pricing; (2) as de facto tying; and (3) as exclusionary conduct that deters entry.*

8.4 Exclusionary Bundling and Parallel Exclusionary Bundling

Under de facto tying, while a consumer can purchase each component of a bundle separately, the prices of the separate components are increased relative to the component prices without bundling

(Muris, 2005, p. 14). This price increase makes purchase of the bundle relatively attractive, even when the prices in the bundle are set at the monopoly level. The bundle appears to offer consumers a discount, but in fact does not, because the price for each separate good has been correspondingly increased, including raising the stand-alone price of the monopoly good above the monopoly price of the good in the absence of bundling.

According to leading Australian competition economists Professor Joshua Gans of the University of Toronto and Dr Stephen King (former ACCC Commissioner and current Commissioner with the Productivity Commission):

> *… a firm may find bundling profitable because of its anti-competitive effects. Bundling may involve practices that are similar to predatory pricing. For example, a firm with a monopoly in one product may tie sales of that product to a second good or service that is potentially competitively supplied. The firm may use the bundled products to undermine competition in the potentially competitive sector, for example by effectively selling the tied product below cost. Even though the bundle as a whole may be priced above cost, rivals are effectively prevented from competing in the potentially competitive sector … (Gans & King, 2004, p. 313)*

A primary concern over bundled pricing strategies is that they may foreclose or exclude equally efficient rivals, even if the discount results in prices that are above the dominant firm's costs (Economides & Lianos, 2009, pp. 488-489). In this regard, courts in various jurisdictions have ruled that bundled discounts may in some circumstances amount to anti-competitive behaviour even when the dominant firm would not be liable under a predatory pricing test (Economides & Lianos, 2009, p. 493).

The European Commission (2005, pp. 54-55) has warned in relation to bundling:

> *A company that is dominant in the tying market can through … bundling foreclose the tied market and can indirectly also foreclose the tying market (horizontal foreclosure). By tying the dominant company reduces the number of potential customers that is available for its competitors in the tied market. This may cause existing competitors to be marginalised or exit from the tied market and create a barrier for new entrants. Economies of scale, network effects and high entry barriers in the tied market all make such a strategy more likely and more successful.*
>
> *The foreclosure of the tied market may allow the dominant company to achieve larger profits in the tied market, for example through catching more of the customers in that market. Moreover, tying may allow the dominant company to protect or strengthen its dominant position in the tying market. If the tied good is important for buyers of the tying good a reduction of alternative suppliers of the tied good can make entry in the tying market more difficult, since it may in the end make it necessary to enter both the tying and the tied market in order to compete effectively.*

Professor Barry Nalebuff (2005) of Yale University has coined the term exclusionary bundling that has a foreclosure effect similar to predatory pricing but also has some important differences. In Nalebuff's model, there is product market dominated by an incumbent firm (non-contestable) and an adjacent market in which buyers are indifferent between the incumbent's and entrant's products (contestable). The incumbent may achieve costless exclusion by bundling contestable and non-contestable demand under a contract with price equal to the sum of prices for contestable and non-contestable demand prior to the bundle. Although the high stand-alone price for the non-contestable product exceeds the incumbent's profit maximising monopoly price, buyers do not

choose to pay the stand-alone price as they prefer to purchase the bundle. The threat is never carried out.

Nalebuff (2005, p. 377) concludes that bundling is exclusionary when the incumbent's pricing makes it unprofitable for an entrant with the incumbent's costs to sell the competitive good at a price that would lead the customer to forgo the bundle. If entry is costly, then entrants may not reappear after exiting, especially if they anticipate that the incumbent can repeatedly drive them out via a costless cross-subsidy (Nalebuff, 2005, p. 325).

Bundling in this manner has several adverse competitive consequences (Scott Morton & Abrahamson, 2017, p. 780). First, the entrant does not expand because they cannot overcome the financial impact of the bundle on buyers' incentives. Once the entrant realises the futility of competing for sales subject to the bundle, other consequences may follow: exit due to lack of scale, less price competition because the entrant does not gain sales by lowering prices, or even higher entrant prices if the entrant retreats to serving a niche group of buyers that already favour its product. Bundling reduces competition in all cases.

The offer by incumbents of a bundle in this manner provides a number of advantages over predatory pricing: the provision of the bundle with a targeted discount in the non-contestable market is cheaper (Scott Morton & Abrahamson, 2017, p. 784). While predatory pricing requires reducing the price on all units today in exchange for uncertain future profits on all units tomorrow, discounts in the non-contestable market allows the incumbent to offer a lower price only on the marginal sales (Scott Morton & Abrahamson, 2017, pp. 784-785).

Professor Fiona Scott Morton of Yale University and Zachery Abrahamson of the US Department of Justice (2017) propose a diagnostic tool for calculating the burden that the bundled pricing imposes on the entrant — the amount by which the entrant must lower its own price below the market price to counteract the impact of the bundled pricing on custom. This "effective entrant burden" measures the extent to which the dominant firm leverages non-contestable demand into anti-competitive exclusion (Scott Morton & Abrahamson, 2017, p. 777).

Under exclusionary bundling, even if a bundle's components are sold above cost, it could still exclude an equally or more-efficient competitors from entering, or remaining in, one or more component markets (Muris & Smith, 2008, p. 404).

Exclusionary bundling is effectively the type of conduct Visa was engaging in when it was tying the offer of cheaper strategic merchant rates for credit card transactions to a commitment from the merchant to process Visa branded dual-network debit card transactions via the Visa network and not through eftpos.

If exclusionary bundling is being practiced by more than one firm, then it becomes parallel exclusionary bundling. Such conduct is not a new phenomenon within card payment systems as outlined in the case study below.

The provision of access to strategic interchange rates on other debit card transactions that are not contestable by eftpos based on the agreement of large merchants to continue to rout DNDCs transactions through the debit card networks of the international card schemes that are contestable arguably constitutes tying conduct that could be categorised as not only exclusionary bundling, but also parallel exclusionary conduct as it is currently being practiced by both Visa and Mastercard.

Case Study on Parallel Exclusionary Bundling

In the 1990s, when ATMs became widespread across the United States, a collection of payment networks, with names like Honor, Maestro, and Shazam, offered retailers the service of processing debit card payments (Hemphill & Wu, 2013, pp. 1205-1206). For authentication these firms relied on a PIN and immediate access to the customer's checking account (Hemphill & Wu, 2013, p. 1206).

Beginning in the 1990s, Visa and Mastercard launched competing debit systems (built into bank-issued ATM cards, which gained a Visa or Mastercard logo) (Hemphill & Wu, 2013, p. 1206). Their systems relied on a signature, rather than a PIN, and had a much higher fee: roughly the same percentage fee charged the retailer for credit card services including similar interchange fees. Signature debit was more vulnerable to fraud (due to the absence of a PIN) and slightly slower (because a signature was required).

In 1996, Visa/MasterCard signature debit interchange fee rates were 10 to 20 times the rates charged for PIN debit offered by the other networks (Constantine, Schnell, Cyr, & Peters, 2005, p. 166). The vast pricing gap between signature and PIN debit completely distorted the incentives of banks in their debit issuance and promotion practices (Constantine, Shinder, & Coughlin, 2005, p. 608). After initially preferring PIN debit, many banks performed an about face and aggressively pushed signature debit products (Constantine, Shinder, & Coughlin, 2005, pp. 608-609). This was because the banks favoured the higher interchange fees they collected on signature debit cards (Constantine, Shinder, & Coughlin, 2005, p. 614). Not only did they now favour the riskier, more costly, slower and less efficient signature debit card product, but they also took active steps to suppress PIN debit altogether (Constantine, Shinder, & Coughlin, 2005, p. 609).

The difference in price led some merchants to seek to refuse to honour the Visa and Mastercard debit cards. However, Visa gave merchants the choice of either accepting both its credit and debit cards or making do with neither (Hemphill & Wu, 2013, p. 1206). In turn, Mastercard followed suit. This demand has become known as the honour-all-cards rule.

The honour-all-cards rule meant that merchants were unable to decline acceptance of a new type of card product even if they thought the cost of acceptance was too high (Bullock, 2010, p. 55). A merchant could not decline to take Mastercard/Visa debit cards unless it was prepared to decline acceptance of credit cards. Since virtually all merchants needed to accept Visa’s and Mastercard’s dominant credit cards in order to remain competitive, they had no choice but to accept Visa/Mastercard debit transactions at supracompetitive prices (Constantine, Shinder, & Coughlin, 2005, p. 606).

The tactics employed by Visa and Mastercard had a profoundly negative impact on PIN debit's share of the debit card market (Constantine, Shinder, & Coughlin, 2005, p. 609). Between 1993 and 2001, PIN debit declined from a 61 per cent share of debit transactions to a 36 per cent share. At the same time, signature debit grew from a 38 per cent share to a dominant 64 per cent share. This massive market share shift occurred even though most industry observers believed that PIN debit was a superior product. As a result, merchants (and their customers) were forced to pay substantial overcharges for signature and PIN debit transactions.

In October 1996, Wal-Mart Stores brought a suit against Visa and MasterCard, alleging that the two networks were illegally tying their credit and debit products (Peppet, 2007, p. 176). The suit alleged that Mastercard and Visa were making excessive profits on these debit transactions (Peppet, 2007, p. 177). Whereas credit cards carry with them an inherit credit risk of default, debit cards, which draw funds directly from the user's bank, should theoretically be less costly to operate. The plaintiffs argued that Visa and Mastercard were requiring retailers to take such debit cards at "inflated" rates through this anti-competitive tying arrangement. In 2000 the case became a class action, with the lead plaintiffs representing approximately five million retailers.

The evidence in the case supported the merchants' position that, but for the honour-all-cards rule, Visa and Mastercard could not have charged credit card-style interchange fees for their debit products (Constantine, Shinder, & Coughlin, 2005, p. 606). Nearly seven years later in 2003 after bringing the action, the United States District Court for the Eastern District of New York decided most aspects of the case in the merchants' favour on summary judgment (Constantine, Schnell, Cyr, & Peters, 2005, p. 175).

In April 2003, Mastercard settled its case on the courthouse steps, only a week prior to the start of trial (Peppet, 2007, p. 177). Although it initially postured that it planned to continue litigation, Visa followed suit two days later. Under the terms of the settlement, MasterCard agreed to pay roughly US$1 billion in damages to the merchant class over ten years, and Visa to pay US$2 billion. In addition, retailers won the right to accept credit cards but not debit cards, or to accept only debit cards processed using a user PIN number rather than the user's signature (for which the retailers pay far less in fees) (Peppet, 2007, pp. 177-178). Finally, both Mastercard and Visa agreed to lower their transaction fees for an interim period from August to December 2003, and then to set fees based on market indicators (Peppet, 2007, p. 178).

The honour-all-cards rule is an example of an exclusionary bundling scheme taken in parallel (Hemphill & Wu, 2013, p. 1206). The rule served both as a way to blunt the competitive threat to credit cards from PIN debit, and to earn additional profits- from the debit market.

The district court and the United States Court of Appeals for the Second Circuit recognised the settlement as "the largest settlement ever approved by a federal court," and "the largest antitrust settlement in history."[1]

1. *In re* Visa Check/MasterMoney Antitrust Litig., 297 F. Supp. 2d at 508; *affd,* 396 F.3d 96, 103, 119 (2d Cir. 2005).

8.5 Application of Competition Law to Exclusionary Bundling

Broadly speaking, competition laws are concerned with two types of anti-competitive conduct (Melamed, 2005, p. 1248). One is collusion: conduct in which two or more firms agree to reduce rivalry between them in order to enable one or both to exercise market power. The other is exclusionary conduct: conduct by a firm or group of firms that weakens rivals or excludes them from the market and can thereby enable the firm or firms engaging in the conduct to gain market power.

On balance, the application of competition law has generally found it much easier to deal with the problem of collusion than exclusion (Melamed, 2005, p. 1248). This is because competition law has had much more difficulty in determining whether exclusionary conduct is anti-competitive (Melamed, 2005, p. 1249).

In most cases, exclusion is a result of conduct that has both efficiency properties as well as the tendency to exclude rivals (Melamed, 2005, p. 1249). The challenge with exclusionary conduct is how to treat conduct that has both efficiency benefits and exclusionary harm. The benefits are usually realised at least in part by the perpetrators while the exclusionary harm is experienced by rivals and indirectly by consumers. In contrast to collusion, which reduces the perpetrators' outputs, exclusionary conduct reduces the output of the excluded rivals.

US antitrust case law has established that a multi-product seller that uses a bundled discount in a way that excludes or eliminates an equally or more efficient competitor unambiguously harms consumers and competition (Dillbary, 2010, p. 1233).

In Australia the competition law applicable to the practices of exclusionary bundling and parallel exclusionary bundling are sections 46 and 47 of the *Competition and Consumer Act 2010* (CCA):

- Section 46 prohibits a firm with a substantial degree of market power from engaging in conduct that has the purpose, effect or likely effect of substantially lessening competition in a market.
- Section 47 prohibits exclusive dealing where it has the purpose, effect or likely effect of substantially lessening competition in a market. In particular, section 47(2) deals with exclusive dealing conduct of supplying goods or services on the condition that the buyer will not acquire goods or services from a competitor of the supplier.

Exclusionary bundling has previously been successfully prosecuted by the ACCC under the previous version of section 46 as well as section 47 of the CCA. Further details are provided in Appendix II.

9. Regulatory Response on Debit Card Issues

9.1 Overview on Regulatory Response

The international evidence is clear that domestic card schemes require government support and/or intervention in some form in order to survive against the international card schemes. If competition were conducted on a truly level playing field then domestic card schemes should be left to compete on their own merits and to wither on the vine if they fail. However, competition between the domestic card scheme and the international card schemes in Australia is not being conducted on a level playing field for several reasons:

- international card schemes are engaging in anti-competitive practices, specifically exclusionary bundling on both a unilateral and multilateral/parallel basis
- LCR is being implemented through persuasion rather than regulation.

The creation of a genuine level playing field would mean that eftpos is no longer dependent on further regulatory intervention from the PSB and RBA in order to survive, and would be empowered

to pursue its diversification and differentiation strategies. If these strategies prove successful, then eftpos in turn will become less reliant on support from its sometimes unenthusiastic membership.

However, the PSB and RBA is failing to create a genuine level playing field through its preferred policy options in the *Consultation Paper*.

9.2 Addressing Exclusionary Bundling

In response to the problem posed by exclusionary bundling, the RBA (2021, p. 2) is proposing:

- **The Bank would explicitly prohibit schemes from engaging in 'tying conduct' involving their debit and credit card products.** This would supplement the implied prohibitions in competition law, helping to ensure that the debit schemes compete solely on the basis of their debit card offerings, thereby supporting competition in the debit card market.

The ACCC has already accepted a court enforceable-undertaking under section 87B of the CCA from Visa in relation to such tying conduct. However, it is unfortunately the case that this proposal does not go anywhere near far enough to address potential anti-competitive conduct and detriment arising from exclusionary bundling being practiced by the international card schemes. The PSB and RBA need to go much further than just prohibiting tying between the credit and debit products of the international card schemes.

The provision of access to strategic interchange rates on other debit card transactions that are not contestable by eftpos based on the agreement of large merchants to continue to rout DNDCs transactions through the debit card networks of the international card schemes that are contestable also constitutes tying conduct that could be categorised as exclusionary bundling, even parallel exclusionary conduct if practiced by both Visa and Mastercard. The RBA needs to prohibit all such tying conduct as a matter of urgency, for if it takes too long, then eftpos could suffer exactly the same fate as BankCard and be forced to exit the retail payments system.

As was the case in relation to tying conduct by the international card schemes in relation to their debit and credit card products, the tying of their strategic merchant rates in relation to non-contestable and contestable debit products also raises compliance issues under sections 46 and 47 of the CCA.

In its consultation paper, the RBA (2021, pp. 14-15) appears to have created a false dichotomy between:

1. Option 1: Leave the ACCC to investigate and take enforcement action against any anti-competitive tying conduct.
2. Option 2: Explicitly address tying conduct.

While the RBA and the PSB should pursue option 2 on a more comprehensive basis, the ACCC should also continue to investigate tying conduct by the international card schemes and its compliance with section 46 and 47 of the CCA.

Competition only has a chance to succeed if a prohibition is instituted against all tying conduct by the international card schemes between their non-contestable services with their contestable services debit card services as well.

9.3 Dual-Network Debit Cards and Least Cost Routing

In relation to regulatory requirements in relation to the issuing of DNDCs and the rollout of LCR, the RBA (2021, p. 2) is proposing some of the following measures:

- The Bank would state an explicit expectation that the major banks will continue to issue DNDCs, with both schemes to be provisioned in all relevant form factors offered by the issuer (such as in mobile wallets as well as physical cards).

- The Bank would state an expectation that all acquirers and payment facilitators (which provide card acceptance services to merchants) will offer and promote LCR functionality to merchants in the device-present (in-person) environment.
- The Bank would state an expectation that the industry will follow a set of principles regarding the implementation of LCR in the device-not-present (online) environment.

9.3.1 Moral Suasion Versus Regulation

Despite ignoring the recommendations of the Black Economy Taskforce, the House of Representatives Standing Committee on Economics, and the Productivity Commission to regulate for LCR, the RBA is essentially relying on moral suasion to facilitate the take-up of LCR.

In the economic sphere, moral suasion can be thought of as an attempt to coerce private economic activity via governmental exhortation in directions not already defined or dictated by existing regulation (Romans, 1966, p. 1221).

Moral suasion is usually thought of as a process whereby banks co-operate with the central bank either for altruistic reasons or out of fear of regulatory sanction (Breton & Wintrobe, 1978, p. 210). However, economists are generally sceptical about the effects of moral suasion (Torgler, 2004, p. 237).

Assuming state entities are acting in the public interest, moral suasion is exerted in the economic sphere only in instances and directions which promote the national economic welfare (Romans, 1966, p. 1222). Assuming rational, profit-oriented economic units, existing private economic activity is already maximising each unit's own economic welfare. The sphere for moral suasion is where individual profit-seeking activity does not maximise the national welfare, i.e., where the private and the social interests diverge. Thus, moral suasion must encourage private economic units to undertake actions that are less profitable for them and which they would not otherwise to choose to make.

There are many objections that can be raised concerning the use of moral suasion as a policy instrument (Romans, 1966, p. 1221). Moral suasion is inequitable in that it rewards noncompliance; where promises, implicit or explicit, are involved, it entails the danger of an overly familiar relationship between regulator and regulatee; its *ad hoc* character adds an additional and unnecessary element of uncertainty to business decisions; and it may frequently be used in lieu of, or as an excuse for not implementing more effective regulatory measures. Where moral suasion is buttressed by implicit or explicit threats, even if the policy fails, the threats might not actually be carried out (Romans, 1966, p. 1222).

The RBA and PSB have received assurances in the past from participants in the retail payments system that have either partially – if not completely – been ignored or reneged upon. On this basis, it should impose an outcome rather an rely on moral suasion and the assurances of unenthusiastic and unmotivated participants.

9.3.2 Dual-Network Debit Cards Versus Single-Network Debit Cards

The RBA (2021, pp. 11-12) is proposing to impose an implicit Durbin Amendment 'lite' style regime in the retail payments system in Australia whereby it would set an expectation that the major banks would continue to issue DNDCs, with two card schemes to be provisioned in all form factors, including mobile wallets, offered by the issuer.[6]

[6] The relevant part of the Durbin Amendment is that networks and their issuers cannot restrict the number of networks on which a debit transaction may be processed to one exclusive network. While the Durbin Amendment does impose some restriction in relation to debit card interchange fees based on the size of banks, these do not apply in relation to the provisions prohibiting network exclusivity.

The RBA (2021, p. 13) has justified imposing a size threshold upon whom the expectation would apply based on the additional cost to small and medium-sized issuers from having to support the cost of two debit networks. This is despite the acknowledgement by the RBA (2021, p. 12) that a widespread shift towards SNDCs could threaten the viability of LCR and that the unravelling of LCR could impose significant efficiency costs on the system as a whole due to the loss of competitive tension between the debit schemes.

If the RBA is concerned about the additional cost imposed upon smaller issuers from supporting two networks in relation to DNDCs, then perhaps eftpos can provide financial compensation in some form to support the continued issuing of DNDCs by such institutions. This could take the form of a direct subsidy payment. Alternatively, it could also take the form of tiered interchange rates for smaller issuers.

This would preserve competition and support the continuation of LCR. It would also permit the RBA to pursue a regulatory option far broader than Option 3 by mandating DNDC issuance for even smaller issuers in addition to major and medium sized issuers.

9.3.3 Least Cost Routing

Given the recommendations of the Black Economy Taskforce, the House of Representatives Standing Committee on Economics, and the Productivity Commission to regulate for LCR, it is indeed surprising that the RBA and the PSB is persisting with its position of seeking to implement LCR through setting "expectations" upon retail payments system participants.

The general case for market intervention and regulation is generally predicated on market failure. Traditionally, the function of government has been seen as a benign corrector of the market economy when it falters (Tollison, 1985, p. 906). In the economics literature, market failure is generally associated with externalities, the provision of public goods, and non-competitive markets. In this case, government regulatory intervention is justified because the unregulated market outcome is perceived to be inefficient and it is believed that the situation can be ameliorated through regulation leading to a more socially beneficial outcome.

The RBA (2021, p. 9) notes that while most acquirers had implemented some form of LCR functionality by mid-2019, most were not yet offering a version that would maximise merchant savings by enabling dynamic routing for each individual transaction. While one major bank has automatically switched on LCR for eligible small merchants where it determined that they would benefit from the functionality, most other acquirers simply advertise the functionality to their customers, and the onus remains on merchants to understand the benefits of LCR and request it from their acquirer. The RBA (2021) further notes that despite the benefits, the take-up of LCR by merchants has remained relatively low.

For various reasons, including anti-competitive conduct, lack of motivation on the part of acquirers who are also issuers, customer inertia and informational asymmetries amongst some merchants leading to adverse selection, LCR is not being taken up even though it is arguably in the best interests of most merchants, especially smaller merchants. This provides prima facie evidence of market failure that justifies some sort of regulatory response on the part of the RBA and PSB.

9.3.3 Payment Functionality of Dual-Network Debit Cards

The RBA (2019, p. 18) has predicted that payment cards seem increasingly likely to be electronic payment credentials that are pushed out electronically to digital devices such as phones and wearables, as opposed to pieces of plastic that are mailed out in the post. The move towards such digital wallets creates challenges for the functionality of DNDCs as well as the viability of LCR over the longer term.

While eftpos is now live in Apple Pay, Google Pay and Samsung Pay across a significant number of banks (eftpos Payments Australia Limited, 2021, p. 20), not all mobile wallets and issuers currently

support the provisioning of both networks on a DNDC; in some cases, only the international scheme is provisioned (Reserve Bank of Australia, 2021, p. 10).

LCR is not possible for digital wallets based on current implementation, because each network is separately provisioned and the wallet presents the credentials of only one network during payment that is typically the network of the international card schemes that is set as the default, but it can be overridden by the cardholder (Reserve Bank of Australia, 2021, p. 10).

In order to preserve competitive tensions between the international card debit schemes with eftpos, it is vitally important that both card schemes on a DNDC are provisioned in all form factors and both methods also need to be presented to the merchants, including in relation to online transactions and mobile wallets.

10. Buy Now, Pay Later

Buy Now Pay Later ("BNPL") is not new as similar types of finance products have been available in-store for several decades in Australia (Blockey, 2021, p. 108). Providers in the past such as AGC and GE Money, and more recently Latitude, Flexigroup and HSBC have been supporting retailers such as Harvey Norman, Bing Lee and JB HiFi for several years with "up to 60 months interest free", "nothing to pay for 6 months" and other similar offers on relatively large purchases.

What makes the new crop of BNPL providers different, such as Afterpay and Zip Co, is that they have been able to deliver digital, mobile phone optimised transactions, with fast approval, for small value purchases and easy to use (both online and at physical point of sale) finance - that can be quickly repaid - targeted to a (generally) younger market (Blockey, 2021, p. 108).

A BNPL arrangement usually involves a contract between the consumer and the BNPL provider, a contract between the consumer and the merchant, and a contract between the provider and the merchant (Australian Securities & Investments Commission, 2018, p. 6).

Merchants are generally charged transaction fees for accepting BNPL payments (Fisher, Holland, & West, 2021, p. 60). Merchants typically receive the full amount of the purchase price (less any fees) upfront from the BNPL provider. Some providers also charge consumers for these arrangements (Australian Securities & Investments Commission, 2018, p. 6). Arrangements are available in-store, online, and sometimes through door-to-door sales.

These arrangements can be cheaper for consumers than some other types of credit because consumers are generally not charged interest and there are limits on the fees that BNPL providers can charge (Australian Securities & Investments Commission, 2018, p. 7). However, consumers can incur missed payment fees.

Consumer research by the Australian Securities & Investment Commission (ASIC) (2018, p. 31) indicated that 74 per cent of BNPL users used a debit card or direct debit from a transaction account to make payments, even though more than half (51 per cent) of users had a credit card.

An issue relevant to the RBA's mandate for promoting payments system efficiency is that the cost to merchants of accepting BNPL payments is typically higher than for other electronic payment methods, such as cards (Fisher, Holland, & West, 2021, p. 60).

Most BNPL providers contractually prevent merchants from charging consumers higher prices for using a buy now pay later arrangement – also known as no-surcharge rules – that prevent merchants from passing on these costs to the consumers who use and benefit from BNPL services (Australian Securities & Investments Commission, 2018, p. 10; Fisher, Holland, & West, 2021, p. 60).

Some card schemes in Australia previously imposed no-surcharge rules upon merchants. According to the RBA (2007, p. 9), the no-surcharge rule had several adverse effects:

In the Bank's view, the no-surcharge rule dulled the price signals to cardholders about relative costs of different payment methods. The rule also limited the ability of merchants to put downward pressure on fees by threatening to charge the customer for using a credit card. It also contributed to the subsidisation of credit card users by all other customers, with the uniform prices charged by merchants for goods and services needing to cover the relatively high costs associated with credit card acceptance.

As part of the credit card reforms, the RBA (2002) announced:

... the end of the restriction imposed by credit card schemes which prevents merchants from recovering from cardholders the costs of accepting credit cards...

The RBA imposed its new standard on surcharging through a combination of regulation and voluntary undertakings. Credit card schemes operated in Australia by Bankcard, MasterCard and VISA were formally "designated" by the RBA as payment systems subject to its regulation under the *Payments Systems (Regulation) Act 1998*. Under the surcharging standard, the RBA enacted regulations that prevented the Mastercard and Visa credit card schemes and the Visa debit card scheme from prohibiting a merchant from imposing a surcharge for the use of a card. American Express and Diners Club provided the RBA with written undertakings to remove restrictions in their credit and/or charge card schemes preventing merchants from charging any fee or surcharge for the use of a card.

Consumers who use the cheapest payment systems are likely to end up paying more, and consumers who use expensive payment systems are likely to end up paying less than each set of consumers would otherwise have paid (Levitin, 2008, p. 3). The effect is a cross-subsidisation of those using the most expensive payment systems by those using the cheapest. The prices that merchants charge for their goods and services incorporate the costs of running a business, so higher payment acceptance costs lead to higher prices for all customers (Fisher, Holland, & West, 2021, p. 65).

While BNPL services may be free or inexpensive for consumers (assuming repayments are made on time), the cost to merchants of accepting BNPL payments may be significantly higher than the cost of accepting other electronic payment methods such as credit and debit cards (Fisher, Holland, & West, 2021, p. 65).

There is limited data available on BNPL merchant fees, with few providers publicly disclosing their average fees (Fisher, Holland, & West, 2021, p. 65). An exception is the largest Australian provider, Afterpay, which reported an average (global) merchant fee of just under 4 per cent for 2019-20 while Zip Co's average fee has been estimated at 3 per cent. This compares to an average fee of less than 1 per cent if the same payment were made directly with a Visa or Mastercard credit card, and less than half a per cent if the customer used a debit card.

Moreover, stakeholders have observed that the cost of acceptance for merchants with bilateral arrangements with BNPL providers can be up to 6 per cent or more, with smaller merchants tending to pay higher rates than larger merchants (Fisher, Holland, & West, 2021, p. 65).

11. Regulatory Response on Buy Now, Pay Later

In relation to the operation of BNPL, the PSB is currently proposing to take no action:

The Board is not proposing to require any 'buy now, pay later' (BNPL) providers to remove their no-surcharge rules at this time but considers that a policy case could emerge in the future and will keep this issue under review. (Reserve Bank of Australia, 2021, p. 4)

While the PSB asserts that it long-standing view is that merchants have the right to pass on costs to users of more expensive payment methods that in turn promotes competition and efficiency in the payments system, it justifies its position for doing nothing in the interim on the basis that no-surcharge rules can sometimes help promote competition in the payments market by helping newer services build up their customer and merchant networks (Reserve Bank of Australia, 2021, p. 4).

The PSB comments that in it reaching its position that it sought to strike a balance between a regulatory environment that encourages innovation by supporting the ability of newer providers of payment services to compete with more established providers (such as card schemes) and providing newer players with an unfair competitive advantage in the medium term (Reserve Bank of Australia, 2021, p. 4).

The PSB has reached the view that there is not a clear public interest case for requiring any BNPL providers to remove their no-surcharge rules at this time as they still only account for a small share of payments in the economy when compared to some other electronic payment methods (Reserve Bank of Australia, 2021, p. 4). However, the PSB also goes on to warn that:

> *… the arguments are finely balanced and a public policy case could emerge in the future if BNPL continues to grow strongly and becomes an even more prominent part of the retail payments landscape. The Board will therefore keep this policy issue under review in light of market developments. (Reserve Bank of Australia, 2021, p. 4)*

It appears the PSB is saying there is a limit on its tolerance in relation to the growth and size of BNPL providers, and that if they grow too much and become too prominent in the Australian retail payments system then it will reconsider their exemptions from the prohibition on no-surcharge rules. In other words, there appears to be growth limit on the size of BNPL providers before such time as their exemption from the prohibition on no-surcharge rules is lifted. Arguably, this could effectively spell the end for the BNPL business model as it relies on cross-subsidies from merchants to finance benefits in order to make the product more attractive for consumers.

With the major banks moving into the BNPL space, further growth and expansion of the sector is virtually guaranteed. The Commonwealth Bank of Australia (CBA) has made a $300 million investment in global BNPL operator Klarna with its intent to make Klarna services available to CBA merchants and also provide a seamless integration for its retail customers (Blockey, 2021, p. 115). CBA (2020) and Klarna will jointly fund and have 50:50 ownership rights to Klarna's Australian and New Zealand business. In October last year Westpac (2020) announced that it had entered into a partnership with Afterpay that will allow Afterpay to provide Westpac transaction and savings accounts and other cashflow management tools to its customers in Australia. Other banks are likely to follow suit.

Competitive neutrality occurs where no entity operating in an economic market is subject to undue competitive advantage or disadvantage (Organisation for Economic Co-operation and Development, 2012, p. 9). The main economic rationale is that it enhances allocative efficiency throughout the economy – where economic agents are put at an undue disadvantage, goods and services are no longer produced by those who can do it most efficiently.

There is obviously a lack of competitive neutrality at the present time in relation to the treatment of BNPL providers being exempt from the prohibition on no-surcharge rules imposed on other payment schemes, a point readily acknowledged by the RBA (2021, p. 4) when it refers to "providing newer players with an unfair competitive advantage in the medium term."

The PSB has justified the current exemption provided to BNPL providers as a means of encouraging innovation by supporting the ability of newer providers of payment services to compete with more established providers (Reserve Bank of Australia, 2021, p. 4). Foreshadowing the decision last year

by the PSB not to lift the current exemption, RBA Governor Philip Lowe said the bank's stance recognised the innovation that instalment products brought to customers and the relatively small overall volume transacted compared with other payment methods (Eyers, 2020).

While this author does not disagree with the sentiment expressed by the PSB in this regard as it is consistent with our previously stated position[7], I do query the quality of the innovation in relation to the latest iteration of BNPL providers.

Most BNPL providers have been engaging in circumventory financial innovation as the consumer protections afforded under the *National Consumer Credit Protection Act 2009* (National Credit Act) do not apply to BNPL arrangements (Australian Securities & Investments Commission, 2018, p. 4). This has meant that BNPL providers did not need to hold an Australian credit licence to provide these arrangements, nor comply with the responsible lending obligations. The National Credit Act does not apply to certain loans, including: low-cost short-term credit (less than 62 days), insurance premiums paid by instalments, bill facilities and staff loans (McLean Roche Consulting Group, 2021, p. 38).

In response, the corporate regulator, the Australian Securities & Investment Commission (ASIC) (2020, p. 4), has had to seek a new product intervention power. The product intervention power gives ASIC (2020, p. 23) a regulatory tool to address consumer detriment arising from BNPL arrangements.

A recent review by ASIC (2020, p. 4) has found that additional costs are borne by some consumers using BNPL who are incurring missed payment fees and who report financial stress and difficulty meeting other financial commitments. Consumer research by ASIC indicated that 21 per cent of BNPL users surveyed had missed a payment in the last 12 months. ASIC also found that some consumers who use BNPL arrangements are experiencing financial hardship, such as cutting back on or going without essentials (e.g. meals) or taking out additional loans, in order to make their BNPL payments on time. ASIC (2020, p. 4) has warned in relation to BNPL that:

> *There is also a risk that consumers may be paying inflated prices for some goods and services when using a buy now pay later arrangement.*

An ongoing lack of competitive neutrality risks entrenching high-cost payment instruments within the Australian retail payments system as well as undermining the competitive position of not only eftpos, but also other payment schemes as well. In order to provide business certainty for all participants in the retail payments system, the PSB needs to specify exactly how big BNPL providers need to become before their blanket exemption from the prohibition on no-surcharge rules is lifted.

12. eftpos Future Prospects

12.1 eftpos an Effective Competitive Constraint

One of the constraints on a firm’s prices is the pressures posed by competitive alternatives (Hovenkamp H. J., 2012). Competitors producing close substitutes impose strong competitive constraints upon each other (Organisation for Economic Co-operation and Development, 2012a, p. 22). In turn, a loose economic definition of a market is that it comprises all those products whose presence constrains the price of a particular product to a level (Carlton, 2007, p. 161). On the other hand, one of the hallmarks of market power is the absence or ineffectiveness of competitive constraints on prices (Fisher & Rubinfeld, 2001, p. 8).

[7] See Davey (2008, p. 8).

As the lowest priced provider of merchant services within the Australian retail payments system, eftpos is a vigorous and effective competitor that provides an effective pricing constraint on the conduct of other card payment schemes. This extends beyond eftpos's own product segment of debit cards to also include credit cards as well. According to the Industry Committee Administration Pty Ltd (2021, p. 13) for NewCo:

> *There is consensus among the Applicants that eftpos is critical to their ability to negotiate against the [international card schemes] and Big Tech …*

In turn, eftpos has been described as "a critical pricing wedge against the [international card schemes] and Big Tech" (Industry Committee Administration Pty Ltd, 2021, p. 13). Small business industry association, the Australian Chamber of Commerce and Industry (2020, p. 2), has observed "[e]ftpos is a low-cost, high take-up payment solution." According to Australasian Convenience & Petroleum Marketers Association (ACPMA) (2021, p. 3), the national peak body representing fuel wholesale and fuel retail businesses in Australia:

> *… the continued unencumbered operation of Eftpos – a uniquely Australian payment service provider that stands independent of the two international card payment services – is essential to the maintenance of competitive tension in the Australian payment services market.*

12.2 Preferred Consultation Paper Options Risks Removing the eftpos Competitive Constraint

Removing a competitive constraint yields poor market outcomes (Ohlhausen, 2017, p. 140). A reduction in competitive constraints usually leads to an increase in market power which in turn could induce welfare decreasing effects (Organisation for Economic Co-operation and Development, 2012a, p. 24).

The continued competitive pricing and tension currently presented by eftpos is at significant risk if the PSB and the RBA persist with their preferred options as outlined in the *Consultation Paper* as it risks condemning eftpos into oblivion.

The international evidence is clear that domestic card schemes require government support and/or intervention in some form in order to survive against the international card schemes. However, competition between the domestic card scheme and the international card schemes in Australia is not being conducted on a level playing field for several reasons:

- international card schemes are engaging in anti-competitive practices, specifically exclusionary bundling on both a unilateral and multilateral/parallel basis.
- LCR is being implemented through persuasion rather than regulation.

The creation of a genuine level playing field would mean that eftpos is no longer dependent on further regulatory intervention from the PSB and RBA in order to survive, and would be empowered to pursue its diversification and differentiation strategies. If these strategies prove successful, then eftpos in turn will become less reliant on support from its sometimes unenthusiastic membership.

The absence of a level playing field and lack of competitive neutrality in relation to BNPL providers also poses a threat to the future viability of eftpos over the medium to longer term.

The exit of eftpos would provide an opportunity for other market participants to raise their merchant service fees, setting the scene for wholesale price increases across-the-board.

The removal of the competitive constraint posed by eftpos will turn Australian card payments into an effective duopoly composed of the dominant international card schemes in Visa and Mastercard. In this regard, ACPMA (2021, p. 4) has recently warned:

… any weakening of Eftpos's position in the Australian electronic transaction services market exposes Australia's fuel retail businesses (and their customers) to the adverse consequences of a duopoly of international payment services providers (i.e. Visa and Mastercard) and risks the quiet and steady increasing of fees for electronic services in a market that is both opaque and complex.

The international card schemes will be the only remaining domestic debit card schemes and already dominate in relation to domestic credit/charge cards. The remaining providers in the domestic credit/charge card space will be a competitive fringe of even higher priced providers that will provide no effective competitive constraint to the international card schemes.

With the absence of a domestic card scheme in the UK and the lack of competitive tension between Visa and Mastercard, the British Retail Consortium (BRC) has found that card scheme fees had increased by 39 per cent in 2017 and 56 per cent in 2018, as measured as a percentage of turnover (Read, 2020). The BRC have asserted the price hikes were "clear demonstrations of an abuse of market dominance".

The international card schemes currently charge small and medium sized merchants somewhere around 44 basis points more for debit card transactions than eftpos.[8] If, following the exit of eftpos, the remaining international card debit schemes were to increase their merchant service fees by further 44 basis points, similar to what happened in the UK, then this would increase net merchant service fees for small and medium sized merchants in order of almost $1.2 billion per annum.[9] The exit of eftpos would also leave the international card schemes unconstrained to raise prices on their credit card products as well.

In considering the question of the extent of the pass through to consumers from lower merchant service credit card fees following reform to the credit card interchange fees, the PSB (2008a, p. 23) has previously observed:

Despite the difficulties of measurement, the Board's judgement remains that the bulk of these savings have been, or will eventually be, passed through into savings to consumers. This judgement is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge.

By the same logic, the removal of the competitive constraint posed by eftpos and the subsequent increase in merchant service fees by the international card scheme duopoly will see some of the this increase in costs imposed upon merchants passed through to consumers. This will come in the form of either additional and/or higher surcharges on card payment transactions or higher merchant prices across-the-board. A discussion on the extent of the cost pass through is provided in Appendix III below.

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[8] Based on slightly below the midpoint between the average gap in pricing between eftpos and the international card debit schemes of 37 basis points, and the largest gap in pricing between eftpos and the international card debit schemes of 52 basis points in 2018-19 as reported by Occhiutto (2020, p. 25).

[9] Based on RBA data series 'C2.1 Debit Cards – Original Series' to determine the value of debit card transactions acquired in Australia on domestically issued debit cards. Assumed eftpos has a share of 36 per cent for the value of transactions made at the point of sale on domestically issued debits cards consistent with McLean Roche Consulting Group (2021, p. 26). Assumed that large retailers represent 50 per cent of the value of debit card transactions acquired in Australia on domesticaally issued debit cards and remain on scheme strategic rates and are thereforce excluded.

12.3 Alternative Options to Preserve the eftpos Competitive Constraint

There are a number of proactive steps the PSB and RBA can take to preserve the competitive constraint provided by eftpos in the Australian retail payments system that are outlined below.

The PSB and RBA need to go much further than just prohibiting tying between the credit and debit products of the international card schemes. Competition only has a chance to succeed if a prohibition is also instituted on all tying conduct by the international card schemes between their non-contestable services with their contestable services debit card services as well.

Despite ignoring the recommendations of the Black Economy Taskforce, the House of Representatives Standing Committee on Economics, and the Productivity Commission to regulate for LCR, the RBA is essentially relying on moral suasion to facilitate the take-up of LCR. The RBA and PSB have received assurances in the past from participants in the retail payments system that have either partially – if not completely – been ignored or reneged upon. On this basis, it should impose an outcome rather an rely on moral suasion and the assurances of unenthusiastic and unmotivated participants.

If the RBA is concerned about the additional cost imposed upon smaller issuers from supporting two networks in relation to DNDCs, then perhaps eftpos can provide financial compensation in some form such as through a direct subsidy or tiered interchange rates for smaller issuers to support the continued issuing of DNDCs by such institutions. This would preserve competition and support the continuation of LCR. It would also permit the RBA to pursue a regulatory option far broader than what it currently contemplated by mandating DNDC issuance for even smaller issuers in addition to major and medium sized issuers.

The small additional cost arising from supporting the continued issuance of DNDCs pales into insignificance from the substantial additional cost that could be imposed on the retail payments system in the event eftpos were to exit, leaving the system at the mercy of the international card scheme duopoly.

For various reasons, including anti-competitive conduct, lack of motivation on the part of acquirers who are also issuers, customer inertia and informational asymmetries amongst some merchants leading to adverse selection, LCR is not being taken up even though it is arguably in the best interests of most merchants, especially smaller merchants. This provides prima facie evidence of market failure that justifies some sort of regulatory response on the part of the RBA and PSB.

In order to preserve competitive tensions between the international card debit schemes with eftpos, it is vitally important that both card schemes on a DNDC are provisioned in all form factors and both methods also need to be presented to the merchants, including in relation to online transactions and mobile wallets.

There is obviously a lack of competitive neutrality at the present time in relation to the treatment of BNPL providers being exempt from the prohibition on no-surcharge rules imposed on other payment schemes. An ongoing lack of competitive neutrality risks entrenching high-cost payment instruments within the Australian retail payments system as well as undermining the competitive position of not only eftpos, but also other payment schemes as well. In order to provide business certainty for all participants in the retail payments system, the PSB needs to specify exactly how big BNPL providers need to become before their blanket exemption from the prohibition on no-surcharge rules is lifted.

Reflecting on the potential exit of eftpos from the provision of retail payment services, the RBA (2021, p. 10) has opined:

> *… as the lowest cost network, its potential exit from the market would result in a significant lessening of competitive pressure in the debit market and would likely result in an increase in both interchange rates and scheme fees, impacting all merchants.*

The potential loss of the eftpos scheme risks the entrenchment of higher cost payment instruments, in turn imposing higher costs upon merchants and ultimately consumers, with potential flow-on inflationary effects. At a time when the RBA is engaging in quantitative easing – effectively printing money – it is questionable from the perspective of macroeconomic stability as to whether through its willful neglect for the plight of the eftpos scheme that it should also be facilitating the proliferation of higher cost payment instruments.

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Appendix I: Overseas Regulatory Arrangements for Domestic Debit Card Schemes

United States

Prior to the enactment of the Durbin Amendment, banks in the United States had routinely issued debit cards that bore the logos of and could be transacted upon multiple debit networks (Durbin, 2011, p. 11). In this environment, merchant acquirers or their processors could often choose which one of the networks whose brands appeared on a card would carry the transaction (Prager, Manuszak, Kiser, & Borzekowski, 2009, p. 27). Merchants generally preferred that their acquirers route PIN debit transactions over the network with the lowest interchange fee, resulting in direct price competition among PIN debit networks.

However, this price competition appears to have diminished and PIN debit interchange fees rose as the largest national PIN debit networks increasingly required issuers to sign exclusive agreements under which they became the sole PIN network whose logo appeared on an issuer's cards (Prager, Manuszak, Kiser, & Borzekowski, 2009, p. 27).

In other arrangements, banks set "priority routing" on their cards, determining which network would process the transactions and imposing the routing on merchants (Hayashi, 2012, p. 88). With merchants having limited freedom of choice among card networks, competition among networks to attract merchants was limited. Lack of competition, the merchants argued, led to excessive interchange fees.

According to US Senator for Illinois Richard Durbin (2011, p. 11), the trend towards exclusivity agreements, particularly when utilised by dominant networks such as Visa, was troubling in three ways:

1. it limited merchant and consumer choice
2. it diminished competition by threatening to drive competing networks out of business
3. it created significant barriers to entry for new debit networks.

The Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), introduced by Senator Durbin, enacted regulation aimed at reducing debit card interchange fees and increasing competition in the payment processing industry. Enacted on 21 July 2010, the Dodd-Frank Act required the Federal Reserve Board to develop a set of rules on debit card interchange fees and on the network routing restrictions set by card networks and banks (Hayashi, 2012, p. 88).

The Durbin Amendment contained two main changes to the Electronic Fund Transfer Act (EFTA):

- Section 920(a) which directs the Federal Reserve Board to place reasonable constraints on the debit interchange fee-setting that card networks like Visa and Mastercard perform on behalf of their issuing bank
- Section 920(b) which prohibits several anti-competitive restrictions that card networks have imposed on other participants in the debit system (Durbin, 2011, p. 4).

EFTA Section 920(b)(1)(A) directs the Federal Reserve Board to issue regulations providing that networks and their issuers cannot restrict the number of networks on which a debit transaction may be processed to one exclusive network (or to two networks which are affiliated with each other) (Durbin, 2011, p. 11). The intent behind this provision was to inhibit the continued consolidation of the dominant debit networks' market power and to ensure competition and choice in the debit network market. The provision seeks to preserve competition and enhances choice by directing the Federal Reserve Board to issue regulations ensuring that a card network and/or issuer cannot directly or indirectly limit a debit card to only be allowed to run on one exclusive network.

EFTA Section 920(b)(1)(B) directs the Federal Reserve Board to issue regulations providing that a network and/or issuer cannot inhibit the ability of a person who accepts debit cards to direct the routing of the transaction over any network that may process such transactions.

The Federal Reserve Bank published new rules, entitled "Regulation II, Debit Card Interchange Fees and Routing," in June 2011 that came into effect on 1 October 2011 (Hayashi, 2012, p. 88). Regulation II contained three main provisions: a cap on debit card interchange fees, a prohibition on network exclusivity arrangements, and a prohibition on routing restrictions for debit card transactions.

The new rules limited the size of the interchange fee that can be received by large banks, defined as banks with assets of US$10 billion or more (Hayashi, 2012, p. 88).

Regulation II also sought to ensure that merchants exercised some degree of freedom to choose among networks (Hayashi, 2012, p. 89). It did this through its provision that prohibited "network exclusivity" arrangements, requiring all banks to make at least two, unaffiliated networks available for processing the transactions of any given debit card. Banks and networks were also prohibited by Regulation II from restricting merchants' freedom to route their transactions over any of the networks available for a given debit card. Prior to this "merchant routing" rule, many banks' priority-routing settings had deprived merchants of any choice over which network to use. There was no exemption from the routing and exclusivity restrictions for small issuers (Hobson Brown & Savoie, 2012, p. 3).

Another important regulatory change ensured that merchants may, if they wished, offer discounts to customers contingent on whether payment is made in cash or by cheque, credit card, or debit card (Hayashi, 2012, p. 89). Previously, some networks had restricted merchants from offering such discounts.

Recently the Federal Reserve Board (2021) issued a clarification to Regulation II that card-not-present (or online) transactions are a "particular type of transaction" for which two unaffiliated payment card networks must also be available. The proposed revisions would further clarify the responsibility of the debit card issuer in ensuring that at least two unaffiliated networks have in fact been enabled to comply with the regulation. This is to ensure that there are no restrictions on merchants' ability to route in the online environment (Reserve Bank of Australia, 2021).

European Union

Article 8 of the European Union regulations on interchange fees for card-based payment transactions addresses requirements in relation to co-badged cards (The European Parliament and of the Council of the European Union, 2015). Amongst the various provisions contained in Article 8 are the following:

- Any payment card scheme rules and rules in licensing agreements or measures of equivalent effect that hinder or prevent an issuer from co-badging two or more different payment brands or payment applications on a card-based payment instrument shall be prohibited.
- Any difference in treatment of issuers or acquirers in scheme rules and rules in licensing agreements concerning co-badging of different payment brands or payment applications on a card-based payment instrument shall be objectively justified and non-discriminatory.
- Any routing principles or equivalent measures aimed at directing transactions through a specific channel or process and other technical and security standards and requirements with respect to the handling of two or more different payment brands and payment applications on a card-based payment instrument shall be non-discriminatory and shall be applied in a non-discriminatory manner.
- Payment card schemes, issuers, acquirers, processing entities and other technical service providers shall not insert automatic mechanisms, software or devices on the payment

> instrument or at equipment applied at the point of sale which limit the choice of payment brand or payment application, or both, by the payer or the payee when using a co-badged payment instrument.

While merchants retain the option of installing automatic mechanisms in the equipment used at the point of sale which make a priority selection of a particular payment brand or payment application, merchants cannot prevent the payer from overriding such an automatic priority selection made by the merchant in its equipment for the categories of cards or related payment instruments accepted by the payee.

Appendix II Australian Case Law on Exclusionary Bundling

Australian Competition and Consumer Commission v Baxter Healthcare Pty Ltd [2008] FCAFC 141

Baxter Healthcare Pty Ltd (Baxter) had entered into long-term contracts with State purchasing authorities (SPAs) in New South Wales, the Australian Capital Territory, Western Australia, South Australia and Queensland for the supply of various sterile fluids as well as peritoneal dialysis products used in the treatment of chronic renal failure (Taylor, 2010, p. 188). Between 1998 and 2001 Baxter was the only Australian manufacturer of sterile fluids, however, competition existed over peritoneal dialysis products (Alden & Eather, 2007, p. 42).

In its negotiations with SPAs for the supply of sterile fluid products, Baxter had elected to bundle those products with peritoneal dialysis products (Taylor, 2010, p. 188). Baxter gave SPAs the option of agreeing to a sole supply agreement for the bundled products, or agreeing to take only the sterile fluid products at a higher item-by-item cost (Taylor, 2010, pp. 188-189).

Proceedings were initially brought by the ACCC in 2005 against Baxter and the SPAs alleging breaches of the then section 46 (misuse of market power) as well as section 47 (exclusive dealing) of the then *Trade Practices Act 1974* (forerunner to the *Competition and Consumer Act 2010*) (Taylor, 2010, p. 189).

In August 2008 the Full Federal Court issued orders declaring that Baxter had breached the misuse of market power and the exclusive dealing provisions of the then *Trade Practices Act 1974* when it entered long term contracts with the SPAs (Australian Competition and Consumer Commission, 2008). The court found that Baxter's purpose in leveraging its market power in sterile fluids was to deter or prevent competitors from being competitive in the supply of peritoneal dialysis products in contravention of the then section 46.

The court also found that the bundling of all of sterile fluids and peritoneal dialysis products into long term exclusive contracts with purchasing authorities in NSW, Queensland, South Australia, and Western Australia contravened the exclusive dealing provisions (Australian Competition and Consumer Commission, 2008). It found that Baxter engaged in this conduct for the purpose and with the effect or likely effect of substantially lessening competition in the peritoneal dialysis products market in contravention of section 47.

According to the judgement by Justice Gyles:

> *Conduct which hindered … competitors from making realistic offers to significant customers in the [peritoneal dialysis] market was likely to substantially lessen competition in that market. In each negotiation, Baxter used its market power in the sterile fluids market to achieve exclusive dealing by means of bundling to endeavour to snuff out competition as it threatened in the [peritoneal dialysis] fluids market. Viewed in context, interference in competition for each relevant*

contract by freezing out realistic competitive offers could be seen as being likely to substantially lessen competition in the [peritoneal dialysis] market.[10]

Appendix III Pass Through

Insights into the extent of the pass through to end users from raising firms' costs can be obtained from tax incidence theory. Tax incidence is the study of who bears the burden of a tax as opposed to the statutory incidence (the legal requirement to remit a tax) (Metcalf, 2008). Tax incidence seeks to determine what portion of an increase in tax imposed on a producer is ultimately paid by the producer in the form of a lower after-tax price, and which portion is paid by buyers in the form of a higher price (Kosicki & Cahill, 2006, p. 606).

The fraction of the change in cost that is passed on to the buyers in the form of higher prices is determined by the relative price elasticities of supply (*ES*) and demand (*ED*) (Kosicki & Cahill, 2006, p. 606). Specifically, the change in the price to consumers (ΔP) relative to the change in marginal cost (ΔMC) stemming from the imposition of the per unit tax is given by equation (1).

$$\frac{\Delta P}{\Delta MC} = \frac{ES}{ES - ED} \quad (1)$$

The incidence of higher costs falls most heavily upon that side of the market that responds least to price (those that are most price inelastic) (Kosicki & Cahill, 2006, p. 607). If the demand curve is inelastic relative to the supply curve the cost will be disproportionately borne by the buyer rather than the seller. If the demand curve is elastic relative to the supply curve the tax will be born disproportionately by the seller. If *ES* is equal to *ED* then the burden is split equally between the producer and the buyer. The fraction of the cost change passed on is 100 per cent when the supply curve is perfectly inelastic (supply curve is flat or horizontal) or when the demand curve is perfectly inelastic (demand curve is perfectly vertical) (Kosicki & Cahill, 2006, p. 607). In all other cases, the pass through rate will be between 0 per cent and 100 per cent.

[10] Australian Competition and Consumer Commission v Baxter Healthcare Pty Ltd [2008] FCAFC 141 at 391.