

## AN ANALYSIS OF VISA AND MASTERCARD MERCHANT RESTRAINTS: ILLEGAL PRICE MAINTENANCE OR A NECESSARY TOOL FOR THE EFFICIENT WORKING OF THE CREDIT CARD NETWORK SERVICES MARKET

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The Competition Bureau is testing the Competition Act's new price maintenance provision in an application against Visa and MasterCard for imposing anti-competitive restraints on merchants. The case falls amid a worldwide examination of these merchant restraints and a debate on credit card economics. The paper discusses the application of section 76 to merchant restraints including considering issues of whether the provision requires resale, whether the provision requires a direct influencing of price, and whether the merchant restraints create an adverse effect on competition. Ultimately, the Commissioner of Competition's approach to price maintenance is novel and will require an extension of the existing jurisprudence on price maintenance to apply to the credit card sector. However, due to limited empirical evidence and conflicting economic theories of credit card markets, the Competition Bureau will likely be unable to meet the burden of proof for showing an adverse effect on competition.

### Introduction

On December 15, 2010, the Competition Bureau (hereinafter "the Bureau") filed an application with the Competition Tribunal (hereinafter "the Tribunal") against Visa and MasterCard for imposing restrictive and anti-competitive rules on merchants who accept their cards.<sup>2</sup> The Bureau brought this claim under s. 76, the price maintenance provision of the *Competition Act*.<sup>3</sup>

This paper will provide an overview of the credit card industry, a discussion of current issues within the industry, and an application of the price maintenance provision to Visa and MasterCard. The paper's critical findings include:

1. The Commissioner of Competition's (hereinafter "the Commissioner") approach to price maintenance is novel and will require an extension of the existing jurisprudence on price maintenance to apply to the credit card sector;
2. The Tribunal will likely find that Visa and MasterCard have market power; and

3. Due to conflicting economic theories of credit card markets, the Bureau will likely be unable to meet the burden of proof for showing an adverse effect on competition.

## **Credit Card Industry Overview**

Consumers pay with credit cards at merchant locations as an alternative to paying with cash, cheque, or debit cards. Credit cards are useful to consumers because they are secure, liquid, and provide instant credit. However, the structure of a purchase involves several complicated steps with multiple parties.

### **1. Parties**

#### a. Four-Party Payment System

The payment system orchestrated by Visa and MasterCard is referred to as a four-party payment system because, in addition to the credit card networks, there are four major participants in each transaction: cardholders, issuers, acquirers, and merchants (See Appendix A for a diagram).<sup>4</sup> The four-party system runs in contrast to a three-party payment system, where a single party contracts with both merchants and cardholders.<sup>5</sup>

- **Cardholders:** Individuals that make purchases from merchants using their credit cards.<sup>6</sup>
- **Issuers:** Financial institutions that issue cards to customers.<sup>7</sup> Issuers set fees and interest rates for cardholders and give cardholders rewards for credit card use.<sup>8</sup>
- **Acquirers:** Banks or other financial entities that supply credit card network services to merchants.<sup>9</sup> These services include authorization and processing of credit card transactions as well as often providing the physical infrastructure to process credit cards.<sup>10</sup>
- **Merchants:** Merchants accept payment in exchange for goods and services.<sup>11</sup>

#### b. Credit Card Networks

While technically called a four-party payment system, credit card networks play an important role in facilitating the effective running of the payment system (See Appendix A for diagram). Credit card networks, such as Visa and MasterCard, provide authorization, clearing, and settlement of transactions for customers who pay using the network's brand of credit card.<sup>12</sup> Authorization involves obtaining confirmation for the acquirer that the issuer has approved the transaction.<sup>13</sup> Clearing and settlement involve the calculation of the net positions of issuers and acquirers, with the net issuers transferring funds over the network at the end of each day.<sup>14</sup>

The two largest credit card networks in Canada are Visa and MasterCard. Credit card networks earn revenue through transaction processing and assessing customers (*i.e.* issuing banks) based on the gross dollar value of cards that carry their brand.<sup>15</sup> According to the Bureau, these two networks represented ninety percent of all credit card transactions in Canada in 2009.<sup>16</sup>

## 2. Fees Paid in Credit Card Transactions

Several fees are paid between the parties of a credit card transaction (See Appendix B for how the fees flow in a credit card transaction). These fees include:

- **Card Acceptance Fee:**<sup>17</sup> The fee that the merchant pays on each credit card purchase. The fee is distributed among the card network, the issuer, and the acquirer. The card acceptance fee is composed of the interchange fee, the network fee, and the service fee.
- **Interchange Fee:**<sup>18</sup> The amount retained by issuers in a credit card transaction. It is the largest component of the card acceptance fee, being approximately eighty percent. The card networks create intricate schedules of default interchange fees that vary by merchant industry, by method of card acceptance, by type of card, and by transaction size.<sup>19</sup> For example, a purchase made with a premium credit card such as Visa Infinite would typically incur a higher interchange fee than the same transaction made with a basic credit card like Visa Classic.<sup>20</sup> In Canada, the fee ranges between 1-3% of the purchase price, which will generally be substantially more than the debit interchange fee of twelve cents per transaction.<sup>21</sup>
- **Network Fee:**<sup>22</sup> The amount retained by card networks on a credit card transaction. While these fees are not disclosed by Visa or MasterCard, Visa has stated that the revenue from a credit card transaction is typically less than 10% of the interchange fee.<sup>23</sup>
- **Service Fee:**<sup>24</sup> (**Merchant Discount**): The amount retained by acquirers in a credit card transaction. This fee is what an acquirer will charge a merchant on top of the interchange fee that represents the acquirer's cost. Unlike the interchange fee, there is no regulation of the merchant discount by the government or by the card networks.

## The Case before the Tribunal

The Bureau filed an application with the Tribunal on December 15, 2010 jointly against Visa and MasterCard under the price maintenance provision of

the *Competition Act*.<sup>25</sup> The application cites three merchant restraints that allegedly eliminate competition for merchant acceptance of credit cards by keeping the card acceptance fee at inefficiently high levels.<sup>26</sup> Merchant restraints are restrictions or rules that a merchant must follow when using Visa or MasterCard. Visa and MasterCard mandate these restrictions in their agreements with acquirers.<sup>27</sup> The merchant restraints include:

1. Merchants cannot encourage consumers to consider cheaper payment methods like debit or cash. (“No Steering Rule”)
2. Merchants cannot add a surcharge to purchases made with credit cards or high-cost credit cards. (“No Surcharge Rule”)
3. Once merchants decide to accept a brand of credit card (*i.e.* Visa), they must accept all of that brand’s cards, including cards with much higher fees. (“Honour All Cards Rule”)

The Bureau alleges that these merchant restrictions result in Canadian merchants paying five billion dollars in card acceptance fees.<sup>28</sup> The Bureau is asking the tribunal to prohibit the restrictions.

### **Context of the Bureau’s Challenge**

At the heart of the Bureau’s challenge is the level of interchange fees because the interchange fee drives the value of the card acceptance fee. Interchange fees are under global scrutiny due to the increased importance of credit cards and a consolidation of merchant power.<sup>29</sup> Unfortunately, much of the interchange fee literature is conflicting with respect to the evaluation of the efficiency effects of these fees.<sup>30</sup> As a result, there is interchange fee litigation in many countries around the world.

In 2009, the Canadian Senate issued a non-binding report on the credit card industry.<sup>31</sup> Among other things, the report recommended that merchant surcharging be permitted with the prices of each payment method being posted.<sup>32</sup> Also, the report recommended that the Honour All Cards Rule should be modified so that merchants do not have to accept higher-cost cards.<sup>33</sup>

As a result of this report, Visa and MasterCard adopted a credit card code of conduct.<sup>34</sup> The code has several requirements that benefit merchants including: (1) increased disclosure by credit card networks and acquirers; (2) minimum notice periods for increases in card acceptance fees; (3) the ability for merchants to decline debit cards from a network, while still accepting that network’s credit cards; and (4) the ability for merchants to grant discounts for different methods of payment.<sup>35</sup> The Commissioner indicated that, while the code of conduct was a positive step, it did not go far enough to solve the issues in the credit card industry.<sup>36</sup>

In March 2011, a class action lawsuit was filed on behalf of merchants in British Columbia against the credit card networks and various banks involved with credit cards. The plaintiffs claim damages for price fixing under the *Competition Act* and for several other common law torts.<sup>37</sup> These allegations are based on the same merchant restraints currently being challenged by the Bureau.

There has been significant U.S. litigation on interchange fees.<sup>38</sup> In 2003, Wal-Mart and Sears challenged the Honour All Cards Rule for debit cards provided by the networks. Visa and MasterCard agreed to pay retailers three billion dollars as a settlement and changed their Honour All Cards Rule with respect to debit cards.<sup>39</sup> In addition, in 2010, the U.S. Department of Justice accused the credit card networks of anti-competitive behaviour on the basis of merchant restraints.<sup>40</sup> Visa and MasterCard settled and agreed to allow merchants to offer discounts, incentives and information to consumers to encourage the use of less costly payment methods.<sup>41</sup>

While surcharging is banned in most countries, many emerging markets have disaggregated credit card fees by allowing surcharges.<sup>42</sup> The interchange fees in these countries are higher.<sup>43</sup> Australia is an example of a developed country that has eliminated the no surcharge rule. In addition, Australia, Mexico, and Japan have mandated lower interchange fees.<sup>44</sup>

### **Application of the Price Maintenance Provision to Merchant Restraints**

Until 2009, resale price maintenance was a criminal offence in Canada. In 2009, a new civil price maintenance provision (Section 76) was put into the *Competition Act* in lieu of the criminal provision. This provision reads (in part):<sup>45</sup>

76. (1) On application by the Commissioner or a person granted leave under section 103.1, the Tribunal may make an order under subsection (2) if the Tribunal finds that

- (a) a person referred to in subsection (3) directly or indirectly
  - (i) by agreement, threat, promise or any like means, has influenced upward, or has discouraged the reduction of, the price at which the person's customer or any other person to whom the product comes for resale supplies or offers to supply or advertises a product within Canada, and
  - (b) the conduct has had, is having or is likely to have an adverse effect on competition in a market.

(2) The Tribunal may make an order prohibiting the person referred to in subsection (3) from continuing to engage in the conduct referred to in paragraph (1)(a) or requiring them to accept another person as a customer within a specified time on usual trade terms.

(3) An order may be made under subsection (2) against a person who

- (a) is engaged in the business of producing or supplying a product;
- (b) extends credit by way of credit cards or is otherwise engaged in a business that relates to credit cards; or
- (c) has the exclusive rights and privileges conferred by a patent, trade-mark, copyright, registered industrial design or registered integrated circuit topography.

The Bureau's application is the first civil price maintenance claim to be brought in Canada. As a result, the provision's elements have never been applied. The approach will likely be similar to the approach taken for the criminal version of resale price maintenance.<sup>46</sup>

The elements of the provision include:<sup>47</sup>

1. **Application of Section 76:** The provision applies to any person whose business involves supplying a product or whose business relates to credit cards.
2. **Agreement that Influences Price:** The provision arises where a supplier, by means of threat, promise or agreement, influences upward or discourages the reduction of the price.
3. **Adverse Effect on Competition:** The conduct has an adverse effect on competition.

Since price maintenance is a civil provision, each element must be proven on a balance of probabilities. Each of the provision's elements will be dealt with below.

### 1. Application of Section 76 - S. 76(3)

The provision applies to both Visa and MasterCard because they are both in a business that relates to credit cards.<sup>48</sup>

### 2. Agreement that Influences Price - S. 76 (1)(a)(i)

S. 76 (1)(a)(i) contains several sub elements including: a) the existence of an agreement, threat or promise; b) the requirement for resale; and c) whether the agreement influenced upwards or discouraged the reduction of the price.

#### a. Agreement, Threat, or Promise

There are agreements between the credit card networks and acquiring banks that require acquiring banks to put merchant restrictions in their agreements with merchants.<sup>49</sup>

### b. Does Price Maintenance Require Resale?

S. 76 (1)(a)(i) contains the language “of any other person to whom the product comes for resale,” which implies that the product whose price is being influenced, must be sold or resold. Historically, all price maintenance claims have been brought in the context of supplier/reseller relationships that deal with consumer goods.<sup>50</sup> The credit card industry is a complex delivery model for services and is less straightforward than a standard downstream consumer goods market. Thus, the traditional application of resale price maintenance does not fit and an extension of the jurisprudence is required for s. 76 to apply to the case at hand.<sup>51</sup>

Visa and MasterCard both argue that s. 76 cannot apply because there is no resale. There is no resale because the services provided to issuers and acquires (the card networks’ customers) are not the same services that are provided to merchants and cardholders.<sup>52</sup>

The Commissioner counters that the price maintenance provision does not require sale or resale; it only requires an agreement that has the effect of influencing upward or discouraging the reduction of the price of a product.<sup>53</sup> Additionally, s. 76 (1)(a)(i) distinguishes between customers and non-customers, with the requirement for resale only applying to non-customers.<sup>54</sup> Since issuers and acquirers purchase services from Visa and MasterCard, it can be argued that they are customers of the credit card networks, even if they do not resell the credit card networks’ products to merchants and cardholders.

Ultimately, it is uncertain whether the absence of resale and a direct supplier will stop the Commissioner’s claim, as s. 76(1)(a)(i) can be interpreted both ways. However, since s. 76(3) specifically lists the credit card industry as a sector to which the provision applies, it is possible that Parliament intended s. 76 to apply to the complex delivery model of the credit card industry.<sup>55</sup>

### c. Conduct Has Influenced Upward or Discouraged the Reduction of the Price

The Commissioner must prove that the merchant restraints created by the credit card networks influenced upward or discouraged the reduction of the price of credit card network services that Visa and MasterCard’s customers supply. The Commissioner contends that merchant restraints discourage the reduction of the card acceptance fee.<sup>56</sup> Merchants pass the cost of the inflated fee on to all consumers, whether they use credit cards or not.<sup>57</sup>

If not for the restraints, merchants would be able to engage in various practices that would force cardholders to internalize the costs of whichever payment method they choose.<sup>58</sup> The effect of this practice would be a reduction in demand for credit cards, especially for those that are high-cost cards.<sup>59</sup> As a result, credit card issuers would either stop offering high-cost cards or would negotiate lower interchange fees on these cards, as there would be a surplus

of credit card issuing services from the decrease in the demand for credit card services.<sup>60</sup>

Both Visa and MasterCard contend that there is no direct connection between the merchant restraints and the card acceptance fee charged to merchants because acquirers are not constrained in their pricing policy of merchants in any way.<sup>61</sup> Furthermore, the card networks argue that the interchange rate, which is the basis of the card acceptance fee, is not a price, but a balancing mechanism that balances the two sides of the card market to maximize overall system output.<sup>62</sup>

Historically, price maintenance convictions have been handed down for coercive attempts directly related to the pricing of a product. An indirect approach to the influence of price, like in the case at hand, has never been applied.<sup>63</sup> Therefore, any holding in favour of the Bureau would require an extension of the jurisprudence.<sup>64</sup>

The jurisprudence has varied widely on the interpretation of “the attempt to influence price.”<sup>65</sup> In *Cluett*<sup>66</sup> and *Phillips Electronics*<sup>67</sup> the provision was interpreted strictly so that it only applied to a limited number of clear cut situations, which suggests that the Commissioner’s creative approach to influencing price would likely be rejected.<sup>68</sup> However, in *Kito Canada*<sup>69</sup> and in *Shell Canada Products*,<sup>70</sup> the courts took a more purposive view and permitted a broader scope of offences to fall under the provision.<sup>71</sup> The mixed jurisprudence suggests that the Tribunal might be willing to permit the Commissioner’s unorthodox approach. In addition, since the provision has now been decriminalized, perhaps there will be a more purposive application of s.76 due to the lower standard of proof and more limited remedies available relative to the old price maintenance provision.

### **3. Adverse Effect on Competition - S. 76(1)(b)**

#### **a. Relevant Market**

In order to establish an adverse effect on competition, the first step is to identify the market in which the adverse effect is occurring. Both parties agree that the relevant geographic market is Canada.<sup>72</sup> However, the parties disagree on the appropriate product market. The Commissioner contends that the relevant product market is the market for supplying credit card network services, while Visa and MasterCard allege that the appropriate product market is the market for supplying all forms of payment services.

A narrower market definition can be accepted if there are there are no effective substitutes for products or services within the narrow market.<sup>73</sup> In the case at hand, the Bureau submits that there are no effective substitutes for credit cards in the payments’ market.<sup>74</sup> Debit cards, cheques and cash are inferior payment methods as they do not provide an interest free period of credit,

rewards for use, or the same level of protection against fraud.<sup>75</sup> Additionally, credit cards have much higher daily limits than debit cards, which are the closest substitute in terms of efficiency and security.<sup>76</sup> Furthermore, the Commissioner cites the fact that debit cards' cheaper pricing has not affected or constrained the pricing decisions of the credit card market to show that debit cards would not harm a credit card network's hypothetical monopoly.<sup>77</sup>

Visa and MasterCard assert that they compete in the global payments industry.<sup>78</sup> They argue that other payment methods can be used to purchase goods in stores and online. Additionally, other payments methods are as generally accepted as credit cards.

Historically, the Tribunal has tended to favour narrower market definitions, which would support the Commissioner's claim.<sup>79</sup> Additionally, for network industries like the credit card market, some commentators believe that a "more precise market definition provides a better tool for analyzing the effect of exclusivity" since the relevant market would include only those parties that are competitively affected by such market restrictions.<sup>80</sup>

There is U.S. jurisprudence on the relevant market when dealing with Visa and MasterCard. In the 1986 *NaBanco* case, the court held that a broad market definition including all payment methods was appropriate.<sup>81</sup> However, in the 2003 case *Visa USA*, the court rejected the all payment methods market in favour of a market limited to credit card network services.<sup>82</sup> The court favoured the narrower market definition based on similar reasons to the ones put forward by the Commissioner discussed above. In addition, the following factors were persuasive to the court:

1. When setting interchange rates, Visa and MasterCard only reviewed each other's rates and not other forms of payments;
2. Internal documents showed that Visa and MasterCard recognized the existence of the narrower credit card services market; and
3. Economic evidence from Michael Katz, an expert testifying in the case, suggested that it was highly unlikely that there were enough cardholders switching away from credit cards to make any price increases unprofitable for a hypothetical monopolist.

In light of the more recent U.S. jurisprudence and Canada's tendency to select narrower market definitions, it is likely that the narrower market definition will prevail.

### b. Market Power

The relevant market is important for determining if Visa and MasterCard have market power. An overly broad market definition often makes it difficult to

demonstrate market power as the competitive effects of challenged restraints appear less significant when evaluated in a larger market.<sup>83</sup> Thus, if the relevant market is held to be the market for the supply of all types of payments, then it will be more difficult to establish that Visa and MasterCard have market power. Visa and MasterCard endorse the broader market view and argue that they operate in a highly competitive market for payment services.<sup>84</sup>

The Commissioner alleges that Visa and MasterCard have market power on the basis of the narrower market definition. First, Visa and MasterCard jointly represent ninety percent of the credit card payments market, a very high level of concentration.<sup>85</sup> Second, Visa and MasterCard successfully price discriminate in setting interchange fees on the basis of the merchant industry, card type, and transaction size.<sup>86</sup> Third, there is evidence that the credit card networks have raised their prices with no resulting decrease in volume.<sup>87</sup> Finally, there is such wide acceptance of credit cards, that if a merchant decides not to accept them, the merchant would be at a competitive disadvantage with respect to other merchants that do accept credit cards.<sup>88</sup>

There are also several significant barriers to entry which demonstrate the sustainability of Visa and MasterCard's market power. The first barrier to entry is the capital cost of developing Visa and MasterCard's networks.<sup>89</sup> Both companies have large global platforms and resources that enable them to effectively compete. It would be both difficult and expensive for a new entrant to develop the necessary infrastructure. A second barrier to entry, and probably the most significant one, is the network effects that the credit card market exhibits.<sup>90</sup> Network effects mean that the value of the product to cardholders is higher if there are more merchants that take the card, and the value of the product to merchants is higher if more cardholders use the card.<sup>91</sup> As a result, a new entrant would have difficulty in acquiring both merchants and cardholders because he would have none to begin with. A third barrier to entry is the cost of developing a credit card brand.<sup>92</sup> Visa and MasterCard have invested significant resources in developing their brands and instilling confidence in the minds of consumers and merchants alike.

Several U.S. cases have assessed Visa and MasterCard's market power. The economics of the U.S. market are likely similar enough to draw valid conclusions for the Canadian market. In *Visa USA*, the court held that Visa and MasterCard had market power because: (1) merchants could not say 'no' to price increases due to customer preferences to use credit cards over other payment methods; (2) Visa and MasterCard had high market concentration; and (3) Visa and MasterCard successfully excluded American Express from being able to get banks to issue its cards by imposing restrictive rules on banks that wanted to issue MasterCard's and Visa's cards.<sup>93</sup> In *NaBanco*, where a broader market definition was found, the court held that Visa lacked sufficient market power.<sup>94</sup>

However, since this case was only against Visa, and not against Visa and MasterCard combined, its holding has limited relevance for the case at hand.

Since the relevant market will likely be the narrower market of credit card network services, and in light of U.S. jurisprudence that supports a characterization of market power when there is a narrower definition, Visa and MasterCard will likely collectively be found to have market power.

### c. Adverse Effect on Competition

The Bureau must also prove that the relevant market is less competitive because of the merchant restraints.<sup>95</sup> To prove an adverse effect, an investigation of the economics of credit card markets must be undertaken. The economics of credit cards is a controversial area of study that has several competing views.

What makes the market for credit card network services unique is that it is a two-sided market.<sup>96</sup> Two-sided markets are economic platforms that have two distinct user groups that provide each other with network benefits.<sup>97</sup> Such a platform can only prosper if it can appropriately coordinate the demands of the two user groups by expanding both markets to have sufficient numbers.<sup>98</sup> For example, video game platforms such as Nintendo's Wii and Sony's PlayStation need to attract sufficient gamers to convince developers to design games for the system, but also need games in order to induce gamers to buy and use the video game console.<sup>99</sup> As discussed above, there are externalities involved in such a market, as the larger the network is, the greater the benefit to both merchants and cardholders.<sup>100</sup>

The interchange fee represents the price in a two-sided market. Since merchants and customers have different preferences and price elasticities of demand, the price that maximizes participation may result in one side of the market paying a lower price than the other side.<sup>101</sup>

### *Visa and MasterCard*

In *NaBanco*, the court assessed the efficiency of the interchange fee system.<sup>102</sup> Based on economic theory put forward by Visa's expert witness William Baxter,<sup>103</sup> the court held that Visa's profit maximizing level of interchange fees is the socially optimal level.<sup>104</sup> Without an interchange fee, the income from cardholders is too small to make it worthwhile for issuing banks to issue cards and the income from merchants was more than sufficient to cover the acquirer's cost.<sup>105</sup> Thus, it was socially optimal because the system solved the imbalances in the costs and revenues on both sides of the market. Without the interchange fee, there might not be sufficient cardholders in the market, as the fees from issuing banks would be too high. Richard Schmalensee's economic theory supports Baxter's conclusion.<sup>106</sup> He postulated that the privately optimal pricing level for banks under imperfect competition is also the socially optimal level

because the credit card networks and society have the same objective of maximizing output.<sup>107</sup>

Visa and MasterCard's arguments seem to be based on the body of economic theory created by Baxter and Schmalensee. They contend that merchant restrictions promote output in the entire network, and that without the relevant restraints, the interchange fee mechanism would not be able to work as effectively.<sup>108</sup> The lack of restraints would make credit cards less attractive to consumers resulting in fewer credit card transactions and a less efficient market for credit card network services.<sup>109</sup> The lower interchange fees are not more efficient as the Commissioner claims. Lower fees would merely transfer wealth from the consumer to the merchant without any economic benefit.<sup>110</sup> In Australia, the regulated lowering of interchange fees did not result in lower prices for consumers, as only five percent of merchants passed on the cost savings.<sup>111</sup> At the same time, issuers raised their rates to cardholders due to the lower interchange rate.<sup>112</sup>

Additionally, Visa and MasterCard contend that the No Surcharge Rule is a consumer protection measure as it protects consumers who prefer the convenience, security, and reliability of credit cards over cash and cheques.<sup>113</sup> Allowing surcharges enriches merchants at the cost of consumers since consumers are now paying the costs of credit card transactions instead of merchants.<sup>114</sup> Even worse, there is no indication that merchants would lower costs since they no longer have to incorporate credit card fees into their pricing. Merchants would most likely charge the same prices and then collect surcharges on top.<sup>115</sup> While there is a transfer of wealth, there is no economic gain. As such, Visa argues that "there is no requirement of law, policy, or commercial practice that the costs associated with a particular merchant service be borne only by a certain subset of customers."<sup>116</sup> In addition, there is evidence from Australia, where the No Surcharge Rule has been removed, that there have been great increases in unjustified surcharges for cardholders, with surcharges reaching as high as ten percent per transaction.<sup>117</sup>

The Honour All Cards Rule is also a consumer protection measure. Without this measure, consumers would not know if their specific card was accepted until they were in the store, even if the sign indicated that their brand of card was accepted.<sup>118</sup> Furthermore, the rule was put in place to prevent merchants from reaching into consumers' wallets and dictating which payment products they can use.<sup>119</sup> Removing the rule would lead to consumer confusion and eliminate consumer choice at the point-of-sale.<sup>120</sup>

The No Steering Rule that the Bureau contends is anti-competitive does not have much effect. Under the rule, merchants can still offer discounts for paying in cash and can essentially engage in any form of steering other than surcharging.<sup>121</sup>

*The Competition Bureau*

In 2006, Frankel and Shampine produced a competing economic theory. In acknowledgement of Baxter, they admit that in a perfect, costless, frictionless world, interchange fees would be neutral.<sup>122</sup> However, in today's world, the credit card networks do not set the interchange rate efficiently due to usage externalities.<sup>123</sup> Under the usage externality theory, the optimal interchange level is where merchants are indifferent between payment methods.<sup>124</sup>

The issue in the market for credit cards is that a usage externality exists, where buyers choose the form of payment, but sellers bear the costs of this choice.<sup>125</sup> This externality exists so long as merchants cannot adjust their prices to reflect the costs imposed by a given payment method. Due to merchant restraints, merchants have limited ability to price flexibly based on payment methods.<sup>126</sup> There are adverse economic effects to several parties as a result:

- **Merchants:** Merchants have no ability to choose payment methods which enables networks to charge merchants inefficiently high interchange fees without consequence.<sup>127</sup>
- **Cardholders:** Cardholders pay the same price regardless of payment choice, resulting in debit, cash and cheque users subsidizing credit card users.<sup>128</sup> Since cash users are statistically less wealthy than credit card users, the poor are subsidizing the wealthy, a socially undesirable outcome.<sup>129</sup> The net impact on cardholders as a group is negative because issuers do not rebate the full benefit back to cardholders (see "Issuers" below).<sup>130</sup> Despite the overall net loss, there is a collective action problem and so consumers continue to use credit cards because they are charged the same price regardless of the transaction's cost.<sup>131</sup>
- **Issuers:** Issuers receive supra-normal profits from interchange fees such that issuers are profitable without charging cardholders fees.<sup>132</sup> In addition, there are switching costs for cardholders and rebating to cardholders is not costless.<sup>133</sup> As a result, instead of rebating the full benefit to cardholders, the issuers have an incentive to engage in promotional rent-seeking activities to increase credit card usage and supra-normal profits.<sup>134</sup> An example of rent-seeking is evidence of increased mail solicitation for credit cards.<sup>135</sup> These solicitation efforts create significant social costs.
- **Other Forms of Payment:** There is reduced output for other forms of payment as credit cards are used above the socially optimal level.<sup>136</sup>
- **Credit Card Networks:** Competition at the point-of-sale between

card networks is eliminated because of the disconnect between the price and the choice of card. Without the incentive to compete, card networks are not motivated to act efficiently.<sup>137</sup>

The Bureau's argument would appear to build off of this economic theory. The Bureau argues that merchant restraints prevent the competitive process from functioning properly. Without the restraints, costs would be internalized by consumers, the demand for credit cards would decrease, and issuers would stop offering expensive cards or would be forced to negotiate lower interchange fees.<sup>138</sup> As a result, the card acceptance fee would decrease relative to other forms of payment and the negative competitive effects discussed above would be prevented. In addition to the consequences articulated by Frankel and Shampine, the Commissioner claims that lifting merchant restraints would also prevent high costs to consumers, since merchants pass credit card costs onto consumers.<sup>139</sup> Furthermore, since consumers do not choose their payment methods based on the cost of that method, there is no incentive for intra-brand competition between types of cards within Visa and MasterCard and there is a barrier to entry as new entrants cannot compete on the basis of lower fees.<sup>140</sup>

Finally, the Commissioner argues that the ability to surcharge is more effective at preventing anti-competitive effects than the discounting that is currently allowed.<sup>141</sup> Discounting is when a merchant lowers the advertised purchase price if a certain method of payment (*i.e.* cash) is used. Surcharging is when a fee is added to the purchase price if a certain payment method is used. Surcharges are more effective because they allow merchants to advertise the single lowest price.<sup>142</sup> Furthermore, the Commissioner argues that consumers react more strongly to paying a surcharge than to foregoing a discount.<sup>143</sup>

### *Is there an adverse effect on competition?*

Currently, there is no certainty as to the proper characterization of the relationship between markets and the socially optimal level of the interchange rate.<sup>144</sup> Major burden of proof challenges include whether enough merchants would go against the merchant restrictions to affect the market and whether issuers and acquirers would react as predicted in the face of new merchant behaviour.<sup>145</sup> Due to the lack of clarity in economic theory and an absence of empirical evidence, the Commissioner would likely be unable to satisfy the burden of proof.<sup>146</sup> Therefore, the Commissioner likely would not be able to prove that there is an adverse effect on competition.

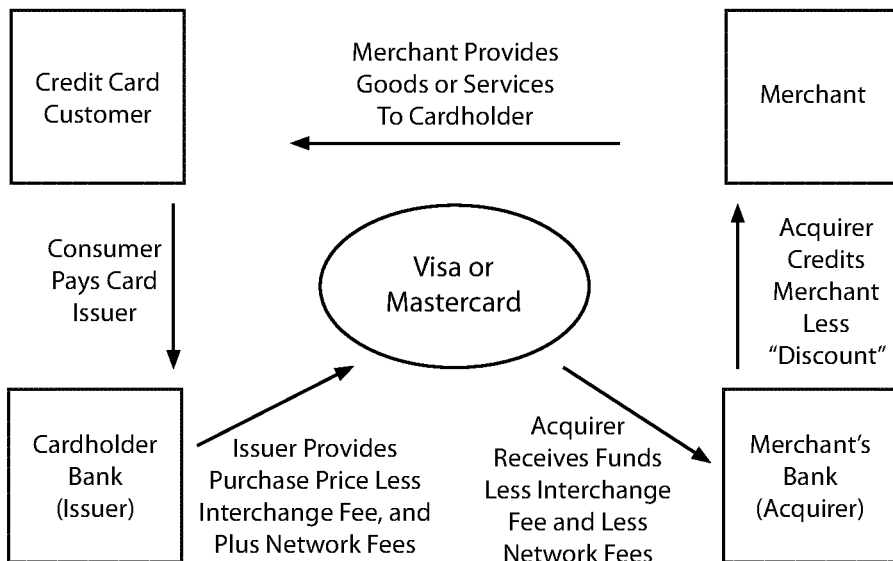
Despite the likely legal outcome, I find the economic theory put forth against merchant restraints more persuasive. In the current model, credit cards are not competing fairly with other payment methods. Technologies such as debit are as convenient and generally accepted as credit cards, yet merchant

restrictions keep the price of credit cards far above the price of debit cards. If future payment methods that were more efficient than credit cards were developed, a major concern would be that the barrier to entry created by the usage externality would hinder the technology's development.

**Conclusion**

This competition policy case falls amid a worldwide examination of interchange rates and corresponding merchant restrictions. It is unclear whether the Bureau's creative approach will succeed in applying to the price maintenance provision because there is no resale and there is no direct supplier influencing price in the traditional sense. However, if the Tribunal decides to extend the law to accept the Bureau's approach, then it is likely that Visa and MasterCard will be found to have market power. Nonetheless, due to the uncertainty of credit card economics, the Bureau will likely be unable to prove, on the balance of probabilities, that there is adverse effect to competition. As a result, the Tribunal will likely not make an order against the credit card networks.

**Appendix A: Credit Card Four-Party Payment System Diagram<sup>147</sup>**



**Appendix B: Steps of Credit Card Transactions<sup>148</sup>**

1. Cardholder presents credit card for payment of goods/services
2. Merchant swipes card and transmits authorization request to acquiring bank
3. Acquiring bank electronically sends authorization request to credit card network
4. Credit card network passes on authorization request to the issuer

5. Issuer approves or declines the transaction (Authorization response)
6. Credit card network forwards the authorization response to the acquiring bank
7. Acquiring bank forwards the authorization response to the merchant
8. Merchant receives the response and completes the transaction accordingly
9. Merchant deposits the transaction receipt with the acquiring bank
10. Acquiring bank submits the transaction to the network
11. Network facilitates settlement with issuer paying the acquirer the price of the goods/services less the interchange rate (Network fee also taken en route)
12. Issuing bank charges the cardholder on his/her monthly statement
13. Acquirer credits the merchant the proceeds of the sale, net of merchant discount

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