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CREDIT CARD INTERCHANGE FEES: ANTITRUST CONCERNS?

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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CREDIT CARD INTERCHANGE FEES: ANTITRUST CONCERNS?

WEDNESDAY, JULY 19, 2006

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The Committee met, pursuant to notice, at 9:30 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Committee, presiding.

Present: Senators Specter, Hatch, Grassley, Kyl, Cornyn, Leahy, and Durbin.

OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. Good morning, ladies and gentlemen. It is 9:30. The Senate Judiciary Committee will proceed now to our hearing on credit card exchange rates and the antitrust concerns raised by existing practices.

Until recently, the two largest credit card companies—MasterCard and Visa—operated as joint ventures among competing banks. The joint ventures MasterCard and Visa worked with member banks collectively to set exchange rates. Late last year, a group of merchants brought suit alleging that when the banks jointly set merchant fees, they violated the antitrust laws. The complaint alleges that the collective setting of interchange rates by banks that compete with each other to issue cards to consumers constitutes illegal price fixing. The higher exchange rates that result are passed on in the form of higher prices for goods to consumers, operating as an invisible tax on every purchase made by consumers.

The merchants contended that the substantial overlap between the banks that are members of MasterCard and those who are members of Visa precludes competition between the two credit card companies, and Visa and MasterCard further prohibit merchants from charging a surcharge to customers who use the credit cards.

The response has been from MasterCard and Visa that the interchange fees do not constitute illegal price fixing, and they point to the case of *Texaco* v. *Dagher*. Obviously, whatever is going on in litigation is a separate matter, and the Judiciary Committee hearings are not intended to and will not affect such judicial action.

When you talk about per se violations and you talk about the rule of reason, that moves over to the area where Congress has the authority to modify the standards on antitrust. So obviously the courts function under the existing rules, but that does not preclude the Congress from setting new rules on antitrust violations.

In May of 2006, MasterCard held an IPO to transfer control of its operation from its member banks to public stockholders, and although banks still own a minority interest in MasterCard, they are prohibited from owning voting stock, which is a sophisticated and subtle way of perhaps seeking to solve the problem, or perhaps not, by relinquishing control.

At the same time, Visa created a Committee composed exclusively of independent members of its board of directors, not the member banks. And as a result of these changes, Visa and MasterCard member banks now contend that they no longer participate in the setting of exchange rates.

Well, that may be so or that may not be so. It is obviously sophisticated legal work to try to divest control, but in the context of what has occurred in the past, and in the context of what the results may be, circumstantially you may have the same result.

I am doing a lot of reading this morning from the memorandum because this is like working through a maze. It is very complicated as to how these arrangements are worked out. And we live today in a plastic world. You do not see money anymore at restaurants. You do not see money anymore in clothing stores. You do not see money anymore in grocery stores. You see plastic all the time.

I have only one credit card personally so I can keep it straight. On the occasion when I do not pay on time, I am astounded at the interest rate. Just astounded.

Australia has gone to price fixing. I am not suggesting that. But I note that the Treasury Department succeeded in stopping Visa and MasterCard from stopping banks from issuing American Express and Discover cards. When I saw that, I was really impressed with the power of Visa and MasterCard to stop banks from issuing American Express and Discover. I thought American Express was a pretty big player.

Well, at any rate, it is very complicated. I have had quite a few complaints from Pennsylvanians and I have had complaints nationally as to what these implications are. So we are going to take a look.

I am joined by my distinguished Ranking Member, Senator Leahy. Senator Leahy?

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Thank you, Mr. Chairman, and I want to thank Vermont State Representative Warren Miller, who came down here with his wife, Kathy, to testify. Leaving Vermont at this time of year is not always the easiest thing to do, and I appreciate it. They have the Elmore Store, in Lake Elmore, Vermont. My first memories of going in there are when I was about 3 years old, with my parents, and getting an ice cream cone. I have been there many times since. I usually drop by and get caught up on the news, and they let me know what I need to know. I look forward to hearing from you. It is one of the last of the really quintessential country stores run by a family, hard-working, that makes it possible for a community to actually have a center.

Now, Mr. Chairman, you mentioned that not too many of us have heard about these interchange fees, and that is true. I am still try-

ing to figure out these fees which retailers pay the bank to process credit card transactions, because ultimately they are going to be borne by the merchant and the consumers.

We are being asked whether these fees are too high and whether they are too high because the associations of banks that handle credit cards are behaving unfairly in the marketplace. Just this week, the European Union's Competition Authority announced that unless Visa and MasterCard change those fees, they are going to face an antitrust action. So it is not an issue we can ignore.

The retailers tell me that interchange fees represent an increasingly large portion of their costs of doing business. They tell me that they are compelled to raise their prices and shift some of that cost burden onto their customers. And the customers then become harmed whether they are using a credit card, a debit card, or paying cash because the prices have to be up to cover the fees that go along with them.

They also tell me—and I hear this from the Vermont Grocers Association and others—that they have not seen the rules for the interchange system. They cannot decipher the complicated billing schemes of the credit card companies.

Now, there are many benefits to both retailers and consumers with credit cards: greater access to consumer purchasing power, more rapid payments, and increased payment options for consumers. In my household, it makes an easy way of keeping track of what we are spending. But you have to make sure that the cost of accepting those credit and debit cards does not outweigh the many possible benefits businesses and consumers should be enjoying. So we need more transparency.

Mr. Chairman, I am sure it is the same in Pennsylvania. But I know the livelihood of many Vermonters depends greatly on the success of our small businesses. We are a State made up of many small businesses that play a very integral part in the community. They are part of the whole fabric of our community. I do not want to see interchange fees force smaller businesses, like the village store run by the Millers in Elmore, to take a net loss in order to both accept credit cards and sell the ice cream cones, the Green Mountain coffee, and everything else that makes a store like theirs a Vermont treasure, because in many of our towns that is the one central spot in the town, unless it is town meeting day when everybody is going to be in the town hall. Otherwise, that is the spot everybody goes.

So we could say how great the Elmore Store is and how wonderful it is. It is very picturesque. I actually have a picture of it. It is a very picturesque place to be. But the family also has to make some money to be able to keep it going.

So, Mr. Chairman, I am glad we are having this hearing, and I will put my whole statement in the record.

Chairman SPECTER. Thank you, Senator Leahy. Without objection, your statement will be made a part of the record.

[The prepared statement of Senator Leahy appears as a submission for the record.]

Chairman SPECTER. Senator Grassley?

Senator GRASSLEY. Could I have just 60 seconds?

Chairman SPECTER. Sure. Senator Grassley, you are recognized.

STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. For several reasons.

Number 1, I obviously owe you and Senator Leahy a thank you for holding a hearing because I was part of a group that asked for it. And then I am embarrassed to say that at 10 o'clock I have to have a meeting with our Ambassador Schwab on a lot of trade negotiations that are going on, so I will not be here very long.

Chairman SPECTER. You are still Chairman of Finance, Senator Grassley.

Senator GRASSLEY. I am trying to be, yes.

[Laughter.]

Senator GRASSLEY. And then thank you, explain that I will not be able to hear all of the testimony. I am going to stay until 1 minute to 10 o'clock to hear what I can. And then to just, I think, emphasize what I heard Senator Leahy said and, Senator Specter, you may have said the same thing about the problems. And it is kind of a balancing act. I am probably one of the problems because I hardly ever use cash for anything. I would just as soon not carry around cash but use my credit card an awful lot for some things that maybe are not as significant purposes.

But I am just astonished by the number of constituents I have come to even Washington or Iowa to complain about the very dramatic increases in charges that we have had on the use of credit cards and asking us to look into it. I do not know where we will come out, but I am glad you are having the hearing so we can look into it.

Chairman SPECTER. Well, Senator Grassley, I had said that we are a plastic society anymore and do not see cash in grocery stores or clothing stores or restaurants.

Senator Durbin, would you like 60 seconds by way of balance?

STATEMENT OF HON. RICHARD J. DURBIN, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator DURBIN. Thank you. Thank you for the hearing.

I am glad you are doing this. I am glad we are talking about this. I hope something good comes of it. We fought for 9 years on a bankruptcy bill that the credit card industry wanted desperately so that people would end up burdened with credit card debt even at the end of bankruptcy. They prevailed, and people now who are running up these credit card bills for everything under the sun are now going to carry that debt past bankruptcy for a lifetime.

As Elizabeth Warren has said, we are creating these many little debtor prisons because special interest groups, credit card companies, and financial institutions are so powerful on Capitol Hill.

It is unlikely that much will come of this hearing, but I thank you for having this hearing. It is a chance that the consumers will have a voice up here, and I think we need much more of that.

I recently went to Reagan National Airport, and I saw a man in front of me use his credit card for a charge of less than a dollar. And I said to the woman at the cash register, "So what is the lowest amount you have ever had anybody put on a credit card here at the cash register?" And she said, "Oh, 29 cents." And I thought to myself this is really out of hand. And when you consider the hid-

den fees that we are addressing here, this is a tax that everybody pays. This is a tax, a 2-percent tax on grocery purchases and a lot of other purchases, that is a being paid over and over at the expense of retail merchants in Vermont and Illinois and Pennsylvania.

So thank you for this hearing.

Chairman SPECTER. Senator Durbin, let me voice just a slight dissent. It is not likely that nothing good will come from this hearing. It is not likely.

Senator Cornyn, you were the early bird here. Would you like 60 seconds, or more?

STATEMENT OF HON. JOHN CORNYN, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator CORNYN. Mr. Chairman, thank you for holding the hearing. I am glad to hear from all the witnesses, but particularly one of my constituents, Mr. Douglass, from Sherman, Texas, so thank you for doing this. I look forward to listening to all the testimony and learning more about this issue.

Chairman SPECTER. Senator Hatch?

Senator HATCH. No, thank you. I am just interested in the hearing.

Chairman SPECTER. We now then turn to our first witness, Mr. Bill Douglass, who is the Chief Executive Officer of Douglass Distributing Company, has a record in corporate America with Exxon and Humble Oil; past Chair of the American Petroleum Institute; served in both the Marine Corps and the Army; born and educated in eastern Pennsylvania; and a bachelor's degree from Muhlenberg College.

Thank you for joining us, Mr. Douglass, and we look forward to your testimony.

STATEMENT OF BILL DOUGLASS, CHIEF EXECUTIVE OFFICER, DOUGLASS DISTRIBUTING COMPANY, SHERMAN, TEXAS, ON BEHALF OF THE NATIONAL ASSOCIATION OF CONVENIENCE STORES

Mr. DOUGLASS. Thank you and good morning, Mr. Chairman, Ranking Member Leahy, and members of the Committee. My name, as said, is Bill Douglass, and I am the CEO of Douglass Distributing Company. And my company, which is headquartered in Sherman, Texas, as Senator Cornyn said, operates 15 convenience stores and supplies gasoline and diesel to other retail locations in the Dallas-Fort Worth area. And I am here today, as said, representing the National Association of Convenience Stores, and I want to thank you all for holding this hearing.

Credit card interchange fees hurt my customers who, in the end, have to pay for all these charges, and they hurt my business. Credit card fees are now the third highest operating cost for my business and for my industry. As a whole, the costs of credit cards are exceeded only by payroll and rent.

I want to emphasize to this Committee that this market is broken and something must be done to fix it. The courts have said that Visa and MasterCard have market power, and I will tell you that the agreements among their member banks to charge the

same fees and fix these fees are outrageous. While I am not a lawyer, I know I cannot agree with my competitors about what we will charge because it is against the law, and that should be just as true for the banks.

About 60 percent of gasoline sales are paid for with credit or debit cards, and this is a staggering number, and it means one simple thing: I have to take these cards, or I will go out of business.

Visa and MasterCard's dominance is very similar to the dominance of Ma Bell before the breakup of AT&T, and protestations by Visa and MasterCard that merchants do not need to accept credit cards rings just as hollow as someone saying we could choose not to have telephone service. It ignores how business is done today. Accepting cards is as necessary as having a phone and other utilities. The market power and actions of Visa and MasterCard make this market completely different than the other two-sided markets the card associations like to talk about. No newspaper, for example, has the nationwide dominance that Visa and MasterCard have. And newspaper executives do not meet to agree on the rates they will charge for advertising. Yet that is just what some banks do as members of Visa and MasterCard.

Recent changes in the governance structure at Visa and MasterCard have not changed this basic problem. The Committee, courts, and antitrust lawyers can debate the legal technicalities of this system, but from my perspective it makes no sense. The average convenience store paid about $40,000 in credit card fees in 2005. The same store only made $42,000 in pre-tax profits in 2005. The fact that businesses in my industry are paying almost as much to the credit card companies each year as they are making before they pay Uncle Sam gives you a sense of just how broken this market is.

My own fees this year are up 33 percent. And even paying all this money, I cannot get a copy of the rates I pay or the rules I must follow. The summaries of the rules on Visa's and MasterCard's websites are clearly inadequate, leaving out hundreds and hundreds of pages of rules. In my industry, the best example of this—or perhaps I should say the worst example—is something called "reason code 96." This code comes up for retailers of gasoline and diesel when the purchase exceeds $50 for a Visa transaction or $75 for a MasterCard transaction. With these high gas prices we have had lately, exceeding these limits has become more common. But Visa and MasterCard say somewhere in their hidden rules that if a gas purchase exceeds these pre-approved levels, they can deny payment to the retailer. This is true even if the consumer pays and does not dispute the bill. This rule, as well as its secrecy, is abusive and amounts to a license to steal.

Let me emphasize that this scheme is very unfair to our customers. The average American family pays $231 in interchange and related fees every year, and that is true whether or not the family even uses a credit or debit card. Because these fees are hidden in the cost of virtually everything we buy, even cash-paying customers ultimately pay for them.

U.S. consumers are paying far more than their share. Even though our rates should be lower than other countries, just one look at the charts that we have over here will tell you something

is wrong here. In truth, this is just a brief glimpse of the problems with this market. We look forward to working with the members of this Committee and the Congress to fix this broken market.

Thank you.

[The prepared statement of Mr. Douglass appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Douglass.

I am going to yield to Senator Leahy to introduce Ms. Kathy Miller, who is from Vermont. Senator Leahy told me yesterday about his plans for August. He is going to be spending the entire month at the "fahm"—f-a-h-m.

Senator LEAHY. In Middlesex, although I was with some Elmore folks, John and Kathy Gilmore, this weekend.

Kathy Miller owns the Elmore Store. Now, I did not—I just want you to know, we Vermonters are proud of each other. This is what the Elmore Store looks like. She is former Chair of the Vermont Grocers Association. She and her husband, who is here, Warren Miller, a State Representative, organized and sponsored the New England dog sled race in Lake Elmore. She volunteers at Elmore's one- room school. And I am just very proud to have them here.

I would have actually worn my Elmore Store T-shirt but it is at the "fahm"—at the farm in Middlesex, Vermont. But thank you, I think Warren is going to give me another one. Thank you.

Chairman SPECTER. Thank you for joining us, Ms. Miller, and the floor is yours.

STATEMENT OF KATHY MILLER, OWNER, THE ELMORE STORE, ELMORE, VERMONT

Ms. MILLER. Thank you. Mr. Chairman, Senator Leahy, and members of the Committee, good morning. I would like to say thank you for allowing me to testify today. My name is Kathy Miller, and I, along with my husband, Warren, and daughter, Kelly, own and operate the Elmore Store in Elmore, Vermont. I am also here today as past Chair of the Vermont Grocers Association and on behalf of the Food Marketing Institute which represents our Nation's supermarkets and grocery stores.

Senator LEAHY. Is your microphone on?

Ms. MILLER. Sorry. I thought I hit it. I would like to read what I prepared and then answer your questions later. I did not realize I was going to be blown up and hanging on the wall there, but I do have more postcards, if anyone would like to see closer up what we look like.

[Laughter.]

Ms. MILLER. And I thought I was the small guy in the picture.

This is the store that we have owned and operated now for 24 years. I am a fifth-generation Vermonter with deep roots in Elmore, Vermont. I am the "Mom" part of the operation while Warren, sitting behind me, is "Pop." Warren was elected to the State legislature in Montpelier 4 years ago. We are not only committed to our store, but our community and our State as well.

You may wonder why we do what we do—7 days a week, 96 hours a week, 364 days a year. To be honest, some days we ask ourselves. But we believe that we can and do make a difference to all the people in the community that depend on us.

My concern as a small independent store may seem small to you, but it is a huge burden for us and very real.

Credit card fees are collectively set by the card associations—Visa and MasterCard—and we have no control over them. They are not negotiable and cannot be added on to the consumer's bill. We cannot set minimum amounts to swipe cards, credit or debit. That is against Visa and MasterCard operating rules, so I am told by our local bank. The fees keep increasing to us, and our profit margin sinks down even lower.

Last year, in 2005, we did $58,500 worth of plastic transactions. The credit card fees to us, out of pocket, were $4,400. Each time a customer swipes their card, it costs us 2.65 percent of the total dollar amount plus a 20- cent fee per sale. In our store we have two gas pumps that we own, not subsidized by any big petroleum company. When the price of gas goes up, so does interchange because the fee is a percentage rate. The banks make more even tough their costs are still the same.

Last year alone, American consumers paid Visa and MasterCard about $30 billion in interchange fees. FMI members have seen their costs for these fees rise 700 percent in the last 10 years.

Since I said I was coming to Washington, D.C., to testify on this issue, I cannot tell you how many of my customers were unaware of the hidden fees. They swipe their cards and think all is free because there is no charge to them at all. Obviously, we lose money on many small transactions and too much on others, so we have to raise prices, but we cannot absorb it all. In the grocery business, we compete by lowering prices, not by raising them. I am not a lawyer or a huge Wal-Mart, but I know this is a huge problem that retailers across the U.S., large and small, are facing. So I ask that you look into this matter seriously. We have streamlined our business as best we can. Maintenance does not get done as it should, less money goes out in payroll, but we just keep absorbing the fees and try to survive.

I would like to ask you on your next ride home, like Senator Leahy is going to do here soon, to look into your small towns and see how many vacant storefronts there are. Just this last winter alone, within a 50-mile radius of us four closed. Some days I feel like I should just turn in my keys, but we cannot. Excuse me.

We are a small town of 850 people with one of two one- room schoolhouses left. We are the hub of the community. So when somebody needs something, who do you call? Mom and Pop at the Elmore Store. We are just trying to keep the doors open.

Thank you.

[The prepared statement of Ms. Miller appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Ms. Miller.

We turn now to Mr. Joshua Floum, Executive Vice President, General Counsel, and Secretary of Visa U.S.A. Before joining Visa, Mr. Floum had a distinguished law practice, was Chair of the California firm of Holmes, Robert & Owen, before that with the San Francisco firm of Heller Erman; an undergraduate degree from the University of California and a law degree from Harvard.

We appreciate your being with us today, Mr. Floum, and we look forward to your testimony.

STATEMENT OF JOSHUA R. FLOUM, EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL, AND SECRETARY, VISA U.S.A. INC., WASHINGTON, D.C.

Mr. FLOUM. Thank you, Mr. Chairman.

Chairman Specter, Senator Leahy, distinguished members of this Committee, my name is Josh Floum. I am the General Counsel and Executive Vice President of Visa U.S.A. I thank the Committee for giving me the opportunity to answer the important question posed, and, Mr. Chairman, I would request the Committee's permission to submit my written testimony for the record.

Chairman SPECTER. Your full statement will be made a part of the record, without objection.

Mr. FLOUM. Thank you, Mr. Chairman.

I am proud to be able to share with this Committee a bit about Visa's history and the tremendous value that we drive to millions of American cardholders, retailers, and large and small financial institutions all around the country. We believe we have been a valuable engine which has helped to fuel the growth and efficiency of the American economy, and we think we continue to improve our products and services every day.

Merchants play a key role within the Visa system. Visa enables the very smallest merchants to have the same payment opportunities as the very largest. Likewise, Visa provides to thousands of community banks and credit unions, large and often very small, who have the ability through our products and service to compete with the largest national banks. And as the merchants have told us, Visa services provide them with guarantee payment, increased sales, and higher profits.

Visa provides enormous benefits to cardholders as well, and these benefits are just as important to us as those we provide to merchants. Visa services allow cardholders to access credit and deposit accounts and gives them zero- liability protection. Card issuers offer cardholders rebates, airline miles, and other benefits designed to encourage cardholders to use their cards. And we have also responded to consumer concerns about the overextension of credit, pioneering the U.S. debit card category in the 1970's. Today, in fact, debit cards, which do not carry interest cards, make up more than half of our transactions.

Clearly, the system is working. When a market is not functioning properly and there is "monopoly-like behavior," one would expect output to be restricted and prices to be pushed up. But neither is the case within the Visa system.

Merchants in the United States today pay a lower rate to accept general purpose payment cards than they did a half-century ago when those cards were first introduced. Visa's pricing today remains lower than its smaller competitor, American Express, for example. Hardly the evidence of abuse of market power, as some merchants claim.

Today, more cardholders and more merchants use and accept the card than ever before. In the past 3 years, more and more Visa cards have been put in the hands of U.S. cardholders. The number of merchant locations accepting the card has grown by almost a million locations—again, hardly the evidence that something is wrong in the marketplace.

Cardholders today can choose between literally hundreds of credit and debit product offerings. Merchants also have many, many choices, with Visa, MasterCard, American Express, Discover, First Data, PayPal, Debitman, Google Checkout, and many others—not to mention cash and check—all vying for business, this is not an industry dominated by one or even a few firms.

Price controls are a severe tool and often harm the people they are designed to protect. Lawmakers, regulators, and courts in the United States have declined the invitation to impose price caps, but regulators in other parts of the world have not exercised similar restraint. The impact of regulation overseas shows that consumers here in the United States would, in fact, be hurt by artificial price controls on interchange.

Let's take Australia as an example. Three years ago, the Reserve Bank of Australia imposed artificial price caps on interchange fees, the same fees that are at issue in discussion today. The Reserve Bank cut rates by some 43 percent, and that regulatory intervention backfired. Cardholders in Australia are paying more for payment cards than they did before, through higher annual fees and finance charges, and they are getting less in terms of reward programs and other rebates. Merchants, meanwhile, have seen their costs of payment acceptance decline, but there is no evidence they have passed these savings onto consumers in the former of lower retail prices. In fact, the Reserve Bank of Australia, which has promised that retail prices would decline as a result of the intervention, has given up even trying to prove the existence of the promised decline.

The Committee poses the question whether there are antitrust concerns with interchange. Our answer is an unqualified "no." The merchants behind these lawsuits will make their arguments in the courts, but we believe we achieved the right balance in values and costs as between merchants and cardholders, and that that issue is a business matter that should be driven by supply and demand in the relevant markets. Indeed, the courts have specifically looked at interchange in the past and in each court decision have decided that interchange does not pose an antitrust problem and, in fact, promotes healthy competition, efficiency, and innovation.

Mr. Chairman, you mentioned the *Dagher* case at the outset, where the Supreme Court said that it is entirely lawful and appropriate for joint ventures to set pricing within their associations. Indeed, there is no other way they could function.

In the past 30 years, Visa has built the most efficient, reliable, and secure payment system in the world. We are very proud to be a part of driving this country's economic growth and efficiency by delivering tremendous value to cardholders and merchants. With more cardholders and merchants participating every day——

Chairman SPECTER. Mr. Floum, how much more time would you like?

Mr. FLOUM. Just 5 seconds, Mr. Chairman.

Chairman SPECTER. Thank you.

Mr. FLOUM. With more and more cardholders and merchants participating today, there is no antitrust problem, no reason for Congress to intervene.

Mr. Chairman, I wish to thank the Committee for giving me this opportunity and stand ready to answer any questions.

[The prepared statement of Mr. Floum appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Floum.

We now turn to Mr. Joshua Peirez, Associate General Counsel for MasterCard; previously was an associate at Clifford Chance, where he was an antitrust litigator; bachelor's degree from Cornell and a law degree from the Brooklyn Law School.

We appreciate your coming in today, Mr. Peirez, and look forward to your testimony.

STATEMENT OF JOSHUA PEIREZ, GROUP EXECUTIVE, GLOBAL PUBLIC POLICY, AND ASSOCIATE GENERAL COUNSEL, MASTERCARD WORLDWIDE, PURCHASE, NEW YORK

Mr. PEIREZ. Thank you. Good morning, Chairman Specter, Ranking Member Leahy, and members of the Committee. My name is Joshua Peirez, and I am a group executive with MasterCard Worldwide. It is my pleasure to appear before you this morning to discuss the highly innovative and efficient MasterCard system and the issue of interchange specifically. I ask that my full written testimony be submitted for the record.

Chairman SPECTER. Without objection, it will be made a part of the record.

Mr. PEIREZ. Thank you. The payments industry is extremely competitive. MasterCard competes against all forms of payment, including cash and checks, other brands such as Visa, American Express, and Discover, a wide variety of debit networks, as well as rapidly growing alternative payment systems, such as PayPal, that did not exist a few years ago. We also compete intensely for the loyalty of financial institutions, merchants, and cardholders. And the result of this competition is that consumers and merchants increasingly prefer to use payment cards for purchases, and there are many reasons for this.

MasterCard cardholders know that they can walk into a store almost anywhere in the world and make a purchase using their card with the security that comes with not having to worry about carrying a lot of cash. Our popular advertising campaign says it best: "There are some things money can't buy. For everything else, there's MasterCard."

Merchants also derive enormous benefits from payment cards. Most importantly, cards increase merchant profits because consumers tend to spend more using payment cards. Cards are also much cheaper and safer than checks, which most merchants don't even accept anymore or only accept locally. It is, therefore, no surprise that the number of merchant outlets accepting payment cards continues to increase. Historically, merchants were the first to recognize the benefits of payment cards when in the 1920's individual merchants began to issue cards to their customers. These programs were inefficient and expensive for merchants to operate, but the powerful desire on the part of merchants to benefit from payment cards created opportunity for others.

In the 1950's, Diners Club and American Express both began to offer what is known as a three-party model in which a single com-

pany issues the cards, contracts with merchants, and operates the system itself. Banks then began to offer their own card programs which have evolved into the four- party systems known as MasterCard and Visa. These four- party systems created even greater efficiencies and benefits by bringing together the cardholders and merchants of hundreds and then thousands of banks to complete transactions.

In a four-party system such as MasterCard, card issuance and merchant-acquiring functions are performed by financial institutions licensed by MasterCard, not by MasterCard itself. Since the inception of these three- and four-party payment systems, merchants have paid a fee called a "merchant discount" in exchange for the benefits of card acceptance. These fees are set in an intensely competitive merchant acceptance environment, and they cover some of the costs and the value the system brings to merchants.

A substantial portion of the benefit provided to the merchant obviously comes from card-issuing activities. In recognition of this reality, the card issuer is paid an interchange fee in a four-party system. In the United States, MasterCard management sets a default interchange fee. Banks are free to use these default fees or to agree to a different fee between themselves. Setting default interchange fees is a challenging proposition that involves an extremely delicate balance. If we set the fees too high, the merchants' desire and demand for MasterCard acceptance will drop. If we set the fees too low, card issuers' willingness to issue and promote MasterCard cards will fall, as will consumer demand for those cards. MasterCard management works extremely hard to set interchange fees at levels that balance the benefits and costs to both cardholders and merchants.

Some have sought to challenge the methods by which MasterCard and its competitor, Visa, set their respective interchange fees on antitrust grounds. To date, these cases have all failed, and the courts have upheld interchange fees as not violating antitrust laws. What the plaintiffs appear to really want are Government-mandated price caps at lower levels than what is offered today. There is simply no precedent for such a remedy under antitrust law. Such a policy also harms consumers. We have one test case of the results of such price caps in Australia which demonstrates that price caps harm consumers and competition. The effect in Australia has been higher annual fees and finance charges for consumers, as well as fewer benefits.

In conclusion, merchants and consumers benefit significantly from the use of payment cards. It is my pleasure to discuss the topic with you, and I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Peirez appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Peirez.

Our next witness is the former Chairman of the Federal Trade Commission, Timothy Muris, who served there from 2001 to 2004. Previously, he had been in the Office of Management and Budget during the Reagan administration. He currently is of counsel to the O'Melveny & Meyers firm, where he co-chairs the antitrust practice; a bachelor's degree from San Diego State and a law degree

from the University of California; a member of the Order of the Coif and associate editor of the Law Review there.

Thank you for being with us today, Mr. Muris, and we look forward to your testimony.

STATEMENT OF HON. TIMOTHY J. MURIS, FORMER CHAIRMAN, FEDERAL TRADE COMMISSION, AND OF COUNSEL, O'MELVENY & MEYERS, WASHINGTON, D.C.

Mr. MURIS. Thank you very much for inviting me to this important hearing. Before I begin, I would like to submit my written testimony and a Law Review article I recently wrote about this topic for the record.

Chairman SPECTER. Without objection, both will be made a part of the record.

Mr. MURIS. Thank you.

As you know, I personally advise Visa on antitrust and consumer protection, but the views that I express today are my own. Let me make three points.

The first is that merchants are wrong to analogize interchange to the paradigmatic case for antitrust enforcement, cartel price fixing. A cartel is a group of otherwise competing firms that fix their prices. When businesses collude, they harm consumers by raising prices above the level that would otherwise prevail. Interchange has nothing in common with this behavior. Unlike the cartel, a four-party payment card system cannot exist without interchange. A default fee reduces the cost of negotiating separate fees between acquirers and issuers.

Moreover, for Visa to succeed, merchants need to honor cards from each of the thousands of issuers. Knowing that all cards must be honored, individual issuers could insist on very high fees. Merchants would then be subject to those fees and would be less willing to accept the network. A default interchange avoids this problem.

The difference between a cartel and Visa is stark. With cartel pricing, an end to the cartel lowers prices, raises output, and increases innovation. The end of interchange will lead to chaos.

The merchants understand this. They do not want interchange to end. Instead, they want lower interchange rates. But this is not an antitrust remedy. One of the fundamental maxims of antitrust is that the market, not Government, should set prices. Indeed, "reasonableness" is never a defense to price fixing.

Interchange began with Visa long ago. Bank of America started a three-party payment card system in California in the 1950s. Because banks were then prohibited from crossing State lines, the bank tried to franchise its system to different States but found few takers. It spun off the system in the 1970s. That spin-off, renamed Visa, began interchange to coordinate the four parties involved, beginning interchange long before they had any significant market share.

My second point is to discuss how prices are set. Payment card systems are an example of a two-sided product connecting two groups of consumers. The challenge for any two-sided product is bringing both sides on board. Newspapers illustrate how most two-sided products set prices. I have today's Washington Post. In a

business sense, this is a vehicle to bring together readers and advertisers. The readers pay very little. The publishers get their money from the advertisers. If newspapers charged us the direct cost of supply, they would lose readers given the alternatives. Without enough readers, there would not be enough advertisers.

And, incidentally, in response to Mr. Douglass' point, if you want to talk about market power, I believe that the Washington Post has a very large share in the relevant market here in the Washington area.

The economics of attracting two distinct groups of consumers drives the pricing. Again, we have readers and advertisers. The value of the two-sided product to one group of customers is determined by its attractiveness to the other. The group with the low-cost substitutes—in this case, the readers—gets the better deal.

For payment cards, the consumer is the king. To compete with the two historically dominant forms of payment, cash and check, payment card systems are priced to provide value to cardholders. The industry has followed this model from its inception. In 1948, the Diners Club card was introduced with a merchant discount of 7 percent. Today, the average discount on American Express is about 2.5 percent, while Visa, which is a larger company, charges about 2.1 percent.

Consumers and merchants clearly enjoy the benefits. Walk into a McDonald's or Subway, and you can swipe your card to purchase a meal. A few years ago, you could not do this. Nobody made those restaurants take the payment cards, but instead they found that the payment systems offered value for a price they were willing to pay.

Let me conclude by noting that the attack on interchange, taken to its logical connection to end interchange, poses a direct threat to the American consumer. I understand the full fury of that consumer when aroused. While Chairman of the FTC, we created the National Do Not Call Registry, and I thank all the members here for their support. I suspect that many Americans feel as strongly about their plastic as they do about their dinner hour.

Thank you. I will be happy to respond to your questions.

[The prepared statement of Mr. Muris appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Muris.

Our final witness is Mr. Steve Cannon, President and Managing Partner of Constantine Cannon; had service on the Senate Judiciary Committee back in the 97th and 98th Congress, where he was chief antitrust counsel of the Judiciary Committee. The 98th Congress was the time of my first service in 1981 when Senator Thurmond was Chairman of this Committee. He is also from South Carolina, and Mr. Cannon received his undergraduate and law degree at the University of South Carolina.

Thank you for being with us today, Mr. Cannon, and the floor is yours.

STATEMENT OF W. STEPHEN CANNON, PRESIDENT AND MANAGING PARTNER, CONSTANTINE CANNON, WASHINGTON, D.C., ON BEHALF OF THE MERCHANTS PAYMENTS COALITION, INC.

Mr. CANNON. Thank you, Mr. Chairman. It is great to be back in this room. I must say it feels a little different on this side of the dais.

On behalf of the Merchants Payments Coalition, I am honored to be able to present this testimony on an issue of extreme importance, not only to the merchant community but to the millions of consumers we serve every day. Merchants Payments Coalition members provide virtually every American with a broad array of goods and services and employ over 50 million people.

To answer the question posed by today's hearing, there are indeed crucial and timely antitrust issues raised by interchange fees. Let me be clear and unequivocal. What Visa and MasterCard and their member banks do is illegal price fixing, pure and simple. While the legal team for the cartel is here today to tell you that it may be price fixing but it is not illegal, both the law and common sense tell us that they are wrong.

It is also important to note that other countries around the world have begun to figure all of this out and are acting quickly and decisively to end this price fixing. Just 2 days ago, as the Chairman referenced, the European Commission conducted a hearing on its preliminary finding that the justification for the current interchange system had no factual basis. According to media reports, EC Competition Commissioner Neelie Kroes called for the end of anticompetitive behavior in the payment card industry or face antitrust action. Last April, she warned that the industry's paradise days may be over.

You have already heard a lot about Australia this morning. All I can say about that is that facts are stubborn things. Interchange rates there are currently one- third the rates in the United States, and what the card association witnesses have not told you is that, in fact, fierce competition has erupted between Australian credit card issuers trying to offer lower and lower interest rates to consumers rather than just trying to give you more miles.

And, by the way, contrary to MasterCard's official written prediction of a death spiral for credit cards in Australia, credit card issuance is up, as is credit card use. In my written testimony, Mr. Chairman, I have cited several press articles to this effect from Australia, including one from last February that says, and I quote, "Australians have never had easier access to a credit card with banks undercutting each other in a battle for the consumer's dollar." That sounds like competition to me.

You have also heard this morning from both MasterCard and Visa that the merchants I represent want price controls. This is not a surprising argument since, in fact, Visa and MasterCard are themselves privately controlling prices through their cartel and have no other reason for anybody else to get involved in the process. As of today, they are very comfortable with imposing a consumer checkout fee on virtually every transaction. Their plea of "Let the market decide" really means "Let us continue to privately regulate the market among ourselves." They refuse to publicly rec-

ognize, of course, that all our merchants have asked for is for Congress to look at this problem and potential solutions, not price controls.

Our friends at the desk here would want you to think that you have only a choice, Mr. Chairman, between a cartel and chaos, and that is clearly not the case. There is a lot in between those two choices.

Now let me turn to how to remedy this problem. On the question of liability for past conduct, that is easy. Only the courts can determine who is liable to whom for past conduct and how much damages should be. But we are not here to talk about litigation this morning. What the industry should look like going forward is a harder question. There are many possibilities that Congress could consider, and I am glad to discuss them or answer any questions the Committee might have.

For the other question which is on everybody's mind today, which is whether the Congress has a role to play, we believe the answer is a resounding yes. And, Mr. Chairman, I reference, as you remember, the breakup of the Bell System in 1982 is a very apt analogy. At that point in time, for 14 years, from 1982 to 1996, Congress deferred to a single Federal judge, Hon. Harold Greene, to make the vast majority of the most important telecommunications policy decisions of that era. I would only add that the arguments you have heard this morning that the payment card system is not broke so do not fix it is almost identical to what the Committee heard from the Bell System 25 years ago and is absolutely wrong. I remember when the Bell System warned that using any piece of telephone equipment that Western Electric did not make would make the entire telephone network come crashing down, not to mention that $2 a minute was a very reasonable price for the miracle of long- distance.

Mr. Chairman, that concludes my remarks. Thank you. I would be glad to answer any questions you may have.

[The prepared statement of Mr. Cannon appears as a submission for the record.]

Chairman SPECTER. Thank you very much for that testimony, Mr. Cannon.

We now turn to the portion of the hearing on questioning by members of the panel for 5 minutes each.

Mr. Peirez, you said that all cases have failed. Was that your testimony?

Mr. PEIREZ. All the cases challenging interchange have failed, yes.

Chairman SPECTER. Well, isn't it true that there were recently 50 cases consolidated in the Eastern District of New York which are ongoing and have not failed?

Mr. PEIREZ. Those cases are pending in the early stages, and we will see where those cases go now. My testimony was that, to date, all the cases had failed.

Chairman SPECTER. Well, those cases have not failed, have they?

Mr. PEIREZ. That is true. They have not failed.

Chairman SPECTER. Okay. I just want to be sure that there are some that have not failed.

Mr. PEIREZ. There are pending cases, yes.

Chairman SPECTER. Mr. Muris, one of the cases alleged that the collective setting of interchange rates by banks that compete with each other to issue cards to consumers constitutes illegal price fixing and that there was a substantial overlap between the banks that are members of MasterCard and those that are members of Visa which precludes competition between the two credit card companies.

Do those facts, if established, constitute a violation of the antitrust laws, in your opinion?

Mr. MURIS. No, and let me analogize what is going on here, and I think Mr. Cannon's reference to AT&T really shows this is not a simple price-fixing case.

If you and Senator Leahy practiced law as competitors and you did nothing else but agree to fix prices, that would be an antitrust violation. If you formed a law firm and you fixed prices, that would not be illegal because you had formed a legal joint venture. And what is happening here—and the *Dagher* case I think makes this clear—is we have a legal joint venture which has the right to set prices.

What we have here is a business dispute. Mr.—

Chairman SPECTER. Let me interrupt you, Mr. Muris. You have already said it does not constitute a violation.

Mr. MURIS. Yes.

Chairman SPECTER. Should it? Should the antitrust laws be modified? It sounds to me like pretty anticompetitive practices.

Mr. MURIS. As you will recall when we met, I learned my antitrust law from Jim Liebler, and Professor Liebler was a strong believer in the market. Underlying antitrust law is a strong belief in the market, and the market should set the prices here. Legal joint ventures have—as the Supreme Court made clear just this year—the right to set a price. Obviously you have the right to change the antitrust law—but you would be changing it in a fundamental way that would be inconsistent with the 116-year history of the Sherman Act.

Chairman SPECTER. Mr. Floum, according to the briefing materials provided to me, the Justice Department successfully challenged MasterCard and Visa rules which prohibited their member banks from issuing American Express and Discover cards. Is that true?

Mr. FLOUM. That is correct, Mr. Chairman.

Chairman SPECTER. Isn't that pretty heavy-handed for that kind of market pressure to be brought on banks so that they do not issue other credit cards from companies as prominent as American Express and Discover?

Mr. FLOUM. At the time we thought not, Mr. Chairman, and the reason is that we believe that what our system does is promote vigorous, what we call "intra-system competition," competition between the banks. Now, I know that—

Chairman SPECTER. You thought that was not a violation, but the Department of Justice disagreed with you.

Mr. FLOUM. That is correct, Mr. Chairman. We did petition to the Supreme Court for certiorari, which was denied, and we, of course, rescinded that rule in accordance with the Court decision.

Chairman SPECTER. Mr. Cannon, does that sound like an antitrust violation to you to have member banks prohibited from issuing other companies' credit cards?

Mr. CANNON. Well, it does and it is. And, in fact, that was a 34-day trial before a Federal judge in New York. It went up through the Second Circuit. The Second Circuit found that, in fact, there was market power that had been exercised, and that is now the law of the land. And I am glad to say that at this point Visa was required to abrogate those rules and, therefore, they had to—and now competition is beginning to flourish on that side as well.

But if I can say one thing about Mr. Muris' response on saying this is not a simple price-fixing case, this is a simple price-fixing case, and everyone is doing a lot to try to make you think that it is really complicated. The problem is that it involves two players in this industry that control 80 percent of the market. So it is price fixing. It just happens to be done by two people with a large market share.

Mr. MURIS. Could I respond to that? No one who raises AT&T as the appropriate remedy I think can credibly claim this is a simple price-fixing case. The unraveling of AT&T and the extraordinary efforts of Judge Greene, the 1996 Telecommunications Act, and the efforts that are needed now to rewrite that law show that this issue is very different than the simple price-fixing case of two lawyers in town—the analogy he is making is that two otherwise competing lawyers fixed prices. The remedy is simple: just tell them not to fix prices. You do not make an analogy to AT&T and get the Congress involved and oversight for dozens of years.

Mr. CANNON. Senator, that actually makes my point precisely, which is this is an industry—it is an industry that needs attention, and I would posit that everybody in Congress thought that for the period of 14 years, it would have been a lot better if Congress was making competition policy and telecommunications policy as opposed to Judge Greene, not to not give Judge Greene his due deference, but that is the position that industry and everybody on the Hill found themselves in.

Chairman SPECTER. The red light went on during that lively exchange, which I did not want to interrupt.

Senator Leahy?

Senator LEAHY. No objection here, Mr. Chairman. I thought it was helpful.

Ms. Miller, let me ask you, we have heard some say, well, we just do not accept credit cards, and if some other store does not want to pay these interchange fees, well, they should not accept credit cards. Tell me how practical that would be in Elmore.

Ms. MILLER. It would not be practical. More and more of my customers come in, they are going by on a little bicycle tour. I mean, they are not carrying cash in their pockets. They have got a card. They come in to get a bottle of water. I make 30 cents on a bottle of water. I have got to swipe their card. It costs me 20 cents plus the transaction fee. So in some instances, like candy bars, they are on sale three for a dollar. Somebody buys candy bar, I might as well just give them the candy bar instead of swiping the card. But it is a matter of survival. It is what customers expect. It is what I need to do to have my business to survive.

If a customer is in my store, just because he is using plastic, he is not going to buy more. They are at the deli. If you were going to buy one sandwich, you are not going to buy two. If you are camping at the Elmore State Park, you need a fishing license, you are not going to buy two. But the expectation is there. They are in Elmore. I appreciate their business and I want to take care of them.

Senator LEAHY. Well, in Mr. Douglass's testimony, he says that—I think I am quoting this correctly, Mr. Douglass—"Congress does not yet have enough information about these fees to come up with a solution to this problem." Well, we are holding this hearing as the first step to get that information. What further or additional information do you think we should have?

Ms. MILLER. I do not have all the answers, but I know that you people have the capability to look into this issue. And it is very huge. It is very real. It is wonderful that the dialogue has started. Even if I had access to the rules on the Internet, I do not have time to sit down and read 1,300 pages' worth of information. I probably would not understand them, and I could not print them off so somebody could—

Senator LEAHY. What if you had the interchange fees appear on the customer's bill? Would that be helpful?

Ms. MILLER. According to the bank that I do business with, that is not legal for me to do. I cannot pass that on to the consumer.

Senator LEAHY. Okay. Well, Mr. Floum, Mr. Peirez, why not just have the interchange fees associated with the credit card transactions appear on the bill? Why shouldn't consumers know what it is actually costing to get the free airline miles, which may or may not be available, or the lower interest rate or the annual fee rate? I mean, shouldn't they know what interchange fees are ultimately costing?

Mr. FLOUM. Mr. Chairman, Senator Leahy, I think it is important to understand that the interchange fees are akin to wholesale rates. They are not fees which are paid by the merchant or paid by the cardholder. They are fees that are paid by the merchant bank—

Senator LEAHY. But why not let us know? I would be interested in knowing. And all this stuff is computerized. It would be very easy to do.

Mr. FLOUM. The feel schedules are available online, Senator, but it would be like going to the Macy's store in Pentagon City and expecting to see the wholesale charges for the various items disclosed at the store.

Senator LEAHY. No. Let's not get off the subject. Mr. Peirez, why not do it?

Mr. PEIREZ. Mr. Leahy, Ms. Miller is perfectly allowed under our rules to post that on the receipt. We do not restrict that. She should discuss it with her bank.

Senator LEAHY. How do you get it?

Mr. PEIREZ. She could ask her bank for it. They are not prohibited from providing it. She can also search on the Internet. They are there.

Senator LEAHY. Ms. Miller?

Ms. MILLER. Just a little example of something that happened in my store the other day. We are still very small. We run in-house charge accounts. Some customers come in, they pay by the week. I had a woman in. It is raspberry season. She bought $108 worth of raspberries. She is going to go home. She wants to make raspberry jam. She goes to get her wallet, her pocketbook, "Oh, I forgot it, but I have got my card in the car and I want to pay my slip. Would you rather have me go get my card and swipe it or would you like me to pay cash tomorrow?" I said, "Have a good night, Alex. Go home, make your jam, come back and pay me cash tomorrow." That is just what is happening.

Senator LEAHY. I still do not understand why we cannot get these fees—I mean, you are able to do everything else, including inundate us with free credit cards or offers of free credit cards. My 5-month-old grandson, he could get one. My former chief of staff's dog could get one. You sure are willing to spend money on that. You ought to be able to open this.

Let me discuss one other area, the issue of piracy. There is a website in Russia called "allofmp3." It sells copyrighted material but without the permission of the copyright owners. Customers are here in the United States. The website is in English. It features American music, none of which has been licensed. So they are selling music, in effect, illegally, but they accept Visa and MasterCard. In fact, those are the only two credit cards that are on the site. It is such a degree of concern that it may be one of the reasons why Russia has failed to get into the World Trade Organization. They will not shut it down.

Now, why don't Visa and MasterCard just pull the plug on that, agree to suspend their services to allofmp3? You do this on some child pornography sites. Why not do it on allofmp3 in Russia?

Mr. FLOUM. We intend to do so, Senator Leahy. Visa deplores any illegal use of its cards, and as you mentioned, whether the issue is Internet pornography, online pharmaceuticals, illegal downloading of music, our rules expressly forbid the unlawful use of the card.

Now, it gets more complicated when you have different jurisdictions involved, and we are trying to enforce that in Russia in the case that you specifically mentioned, and we hope to be able to shut down that merchant very soon.

Senator LEAHY. Mr. Peirez?

Mr. PEIREZ. We prohibit and deplore the use of our system for any illegal activities, including this activity.

Senator LEAHY. Are you going to shut down this Russian site?

Mr. PEIREZ. Yes, we are working on it.

Senator LEAHY. Okay.

Mr. CANNON. Senator, may I add one thing about your question about the receipt? We believe that the rules of Visa and MasterCard actually prohibit merchants from doing exactly that, which raises the entire question about all of the rules that are hundreds and hundreds of pages long that the associations essentially keep hidden from the merchants. They have told us time and time again, they have been asked time and time again to make rules available, and now, frankly, even this Committee is not going to be able to get them unless they have a change of heart. They an-

nounced this week they would make them available online to merchants but, in fact, would exclude things dealing with interchange fees, of all things.

So it would be very helpful if the merchants could actually see these rules.

Chairman SPECTER. Thank you, Senator Leahy.

Senator Kyl?

Senator KYL. Thank you, Mr. Chairman, and I appreciate you holding this hearing. I confess that this is a subject that is very confusing, I think, to a lot of folks, including me, and I think it is wise to at least try to understand it better. And for that reason I would like to go back to a more basic or fundamental point.

People have told me that the reason for concern here is that fees have gone up rapidly, I gather much more rapidly than other cost-of-living increases. And it has created a suspicion that there must be some reason for this other than market factors, like collusion, for example. And, of course, there are a series of lawsuits that have been discussed here that attempt to reach that.

The question, the fundamental question I have, is: What market protections are in place to ensure that, at least over time, pricing adjustments are made to truly reflect the state of competition, the value of these interchanges, the value of the product, in effect? How does the market work? Is there a place where it is not working? And if not, why?

I pose this to all of you, and I think it would be good to get both points of view here.

Mr. FLOUM. Senator, I would be happy to try to respond. We call it a two-sided market, so when you ask the question about the marketplace, we look at both merchant demand and cardholder demand. And unless you have enough cardholders, merchants will not be interested in accepting the card. Unless there are enough merchants that accept it, cardholders will not use it. So we need to try to balance so that the product is attractive to both.

If interchange rates are too high, merchants will not use the product. We heard the example of raspberries with cash the next day. It demonstrates that merchants do have a choice to use the card products or to use other payment devices.

On the card-issuing side, if cardholders are asked to pay too much in terms of annual fees, interest rates, other devices that financial institutions use to recoup their costs on the cardholder side, then cardholders will not be interested.

So I think there is an inherent balance that is built into this two-sided market.

Ms. MILLER. Could I just say something?

Senator KYL. Yes, ma'am, go ahead.

Ms. MILLER. The point that I was trying to make was I am small, that was a local customer. She had no idea, until we started talking about what fees were like, what I had to deal with. She felt bad. She apologized to me for swiping her card in my store. So, yes, I did have the option in that situation.

But nine times out of ten, that option is not there. You are busy. Your store is full of people. You are scooping ice cream cones. You are making sandwiches. You are pumping gas. You are just doing business, and it is costing us way too much.

Thank you.

Senator KYL. Mr. Cannon?

Mr. CANNON. Senator, when competitors get together and are allowed to fix the price of what they are going to charge someone else, that is fundamentally not the free market, and that is exactly what we have here today. And it does not matter whether it is two-sided markets or a four- party system or two times four. It makes no difference. We have to keep this simple and keep focused on exactly what is going on today. It is not complicated. It is price fixing. It is in the open. It is not secret. It is not collusive. The question is, Is it a violation of the law? And it truly is.

So in a situation where people are involved in an antitrust violation and they are then deemed to be in violation of the law, they have to stop doing that illegal activity. So the question is: If you cannot fix prices, what else can you do? Every other business in the United States manages to do their business without fixing prices, and surely Visa and MasterCard could as well.

Senator KYL. To you or anyone else, Mr. Muris maybe, there is a legal remedy here. There are plenty of lawsuits that are resolving this, and it just takes a couple of them to establish the law in this area. Is that the preferable remedy here to any kind of Congressional action?

Mr. MURIS. Obviously, the issue is in court, and if they think it is an antitrust violation, they have that forum.

To respond to the basic questions, I have one of every kind of card, and these are Discover and American Express. From the standpoint of merchants, they are identical because the merchants pay a merchant discount, as they do with Visa and MasterCard. But because they are not organized as joint ventures, they are not part of these lawsuits, even though they do the exact same thing. They are organized as individual companies in the way that MasterCard has now just recently organized.

The reason that Visa and MasterCard are organized the way they are is a historical anomaly. As I mentioned in my testimony, when Visa began and MasterCard began, the law prohibited interstate banking. So if Bank of America in California, had this great idea, if could not take the idea to America by using Bank of America across the country. It had to form this cooperative.

The last point is, in a legal joint venture, just as in the law firm analogy I said where it is completely legal to fix prices, interchange fees are used to fuel the enormous competition between the thousands of issuers. Interchange fees result in enormous benefits. I have a Cap One miles card. I have a MasterCard that gets me cash back. It is double cash back at gas stations, which is particularly valuable at the moment. These fees result in benefits to consumers. I get the float and the convenience. I do not have to carry cash. Cards are enormously beneficial, and it is why this is one of the great innovations of the last century, this payment card system, and it costs billions of dollars to put it to where it is today.

Mr. CANNON. Senator, if I may respond to Mr. Muris, he has made my point for me. These miles and other benefits and things, ask yourself, Who pays for these? And the answer is you pay for them. Not only you pay for them as a credit card customer; every single customer of every single retailer and every single merchant

pays for it as well, because it is pretty clear and undisputed that that price gets baked into the price of what we pay every day for everything.

So when you think you are getting a great deal for your miles, you really ought to ask yourself, gee, if I am making that much, how much is somebody else—how much is going out of my other pocket?

Mr. MURIS. But, Senator, and my good friend Steve—we have been friends for a long time—his merchants, if they want, could say I will give you a better deal if you pay me cash. They could discount for cash. It is perfectly legal. Almost none of them do. The gas stations tried a long time ago for a while, and they do not now because it is less convenient and because many consumers would resent it.

We have a system where the consumer is king, and the consumers like their plastic.

Chairman SPECTER. I have a couple of hands up at the end of your questioning. Mr. Douglass, proceed.

Mr. DOUGLASS. Mr. Chairman, thank you for the chance to do this. The difference between American Express and Discover and Visa and MasterCard is Visa and MasterCard have 80 percent of the market. They are just the dominant leader. I mean, they control the market. And back to Senator Leahy's question about can we post the price, the problem is we only get the average price of what they are charging us. We cannot tell what they are charging us for one of these reward cards when they swipe that card in our dispensers at the pump. That is a different rate than if they have a non-reward card. So they have all these different rates, and we get an average. So we would have to have a computer to determine whether they are using a PIN number or whether they are using a remote swiping device. So it is very complicated.

And back to the point that the counsel here has a card that gives him double the money back at his pump, we pay for that at the pump. It takes 50 percent of our gross margin at the pump to pay that credit card charge for that particular refund.

Chairman SPECTER. Mr. Cannon, you had your hand up for a response to Senator Kyl's last question.

Mr. CANNON. I do, Senator. Mr. Muris, responding to the other question, saying, Gee, the rules say you can discount for cash, well, our merchants, the impression or understanding they have is you cannot do that unless you are willing to post a cash price and a credit price on every single item in that store.

Now, I will tell you, what would be great, what might end this argument, this debate, is if we could see the rules. It would be a great thing. But, unfortunately, that has not been the case, and the merchants are given very thin documents, very short summaries of things to be able to say, oh, here is what you have to do.

Now, I will tell you, if a merchant violates the rule, they are the first to tell you very quickly. But, gee, having a copy of the rules to begin with is a much harder thing.

Chairman SPECTER. Mr. Peirez, you had your hand up in response, again, to Senator Kyl's question?

Mr. PEIREZ. Thank you, Mr. Chairman. I actually wanted—

Chairman SPECTER. Senator Kyl may turn out to have a 15-minute round here.

[Laughter.]

Mr. PEIREZ. Thank you, Mr. Chairman. I actually wanted to respond to a couple of points.

First of all, all of the MasterCard rules that apply to the merchant side of the business are available in their entirety online, on our website, mastercardmerchant.com, including our discounting for cash rule, which says nothing about posting two separate prices. We have heard that allegation before. I can tell you right here right now, if a merchant wants a sign at the cash register saying a discount of blank is afforded for the use of cash, our rules do not prohibit that, and the applicable rules are available to the merchants.

Second, I would like to respond to what is a convenient shorthand for people when they try to refer to this alleged market power by saying there is this 80-percent figure. MasterCard and Visa are fierce competitors. MasterCard is currently a public company in majority public hands, with all voting stock in hands independent of the financial institutions that participate in our system. And we are simply not an overlap or a proxy for our competitor Visa. And to lump us together like that, is inorrect. Even the Court in the Department of Justice case that you mentioned, Mr. Chairman, has recently found that MasterCard alone does not have market power. And so it is simply untrue. And when MasterCard sets its interchange rates, we do so as an independent public company today. We believe the way we did it in the past was justifiable, as it was upheld in the *NaBanco* decision and other court cases.

So thank you for the time.

Chairman SPECTER. We had gone to Senator Kyl before Senator Durbin, although Senator Durbin was here earlier, because of the rule of alternating, but we will await Senator Durbin's return. I know he had other commitments, but we would like to—we will keep going a while longer here to give him a chance to return.

Mr. Douglass, staff advises me that you are not permitted to have a surcharge for people who use credit cards. Would you like to be able to have the freedom, if you chose, to have a surcharge for people who use MasterCard or Visa?

Mr. DOUGLASS. Mr. Chairman, no, I would not like to be able to have a surcharge. That would just drive the customers off. People really have been sold on plastic, and it is a real convenience, and we are on that system.

The dilemma we have is that the charges just keep escalating. As I say, my costs have gone up 33 percent this year because of the escalating price of fuel, primarily.

Chairman SPECTER. Is it true, Mr. Peirez, that there cannot be a surcharge?

Mr. PEIREZ. We do not allow surcharging.

Chairman SPECTER. Well, why can you get a discount for cash, but you cannot allow a surcharge? Just six of one and half a dozen of another.

Mr. PEIREZ. It economically should be the same equivalent to a merchant that is looking to drive people to cash. However, we do not like having people using our cards feel that they are being dis-

criminated against. It is a rule, however, that we continue to look at. We do allow surcharging in Europe and in Australia today. The U.S. is our largest and most important market. We tend to be a little slower to move here.

Chairman SPECTER. I am glad to hear that you are looking at it because it is exactly the same thing.

Mr. Cannon, MasterCard and Visa have made some structural changes here. They have transferred control of operations from member banks to public stockholders. Member banks can still have a minority interest, but it is nonvoting. MasterCard has made a change. Visa has created a Committee composed exclusively of independent members of the board of directors, not member banks, which make all the decisions regarding interchange fees. Have these changes eliminated the controls so that there is not a violation of antitrust laws under existing law?

Mr. CANNON. Yes, sir, it is. What they are trying to do is simply promote a little form over substance. It is very clear—and I devote about two pages in my written testimony to this, Senator. Yes, it does not make a difference. The activity that is going on is still unlawful and should be stopped.

Chairman SPECTER. Well, why is it unlawful if they have structured it so that the banks do not have control over the fee setting?

Mr. CANNON. Well, Senator, in fact, if you—and I will be glad to submit this for the record. If you look at the S–1, which is the registration statement that MasterCard filed, it is very educational on this point, and it says clearly and unambiguously that the banks are—the banks still, by the way, hold 44 percent of the stock of MasterCard, the new company. And, in fact, it says, "Our success or failure will still be dependent upon our customers. And who are our customers? Our customers are banks."

And so I can tell you, there is every incentive for this activity to continue regardless of the form, and the fact that MasterCard now says it has an independent board making this decision, what is the definition of "independent"? I think everyone in business wants to make sure that they bring as much to the bottom line as they can, and that is exactly what will still happen.

Chairman SPECTER. Mr. Peirez says that all of the rules of his company are publicly known. Is that true, too, with you, Mr. Floum, with your company?

Mr. FLOUM. It is, Mr. Chairman.

Chairman SPECTER. Well, where is the discrepancy?

Mr. CANNON. I have not seen them. I would love to see them. And my understanding, Senator, was that Visa—

Chairman SPECTER. Don't you have a website, Mr. Cannon?

Mr. CANNON. We do. We do. But my understanding was that Visa was going to announce this week—

Chairman SPECTER. But they say you can look on their website and find out. This is a pretty simple question of fact.

Mr. CANNON. I do not think it is there, Senator. I was told that Visa was going to announce this week it was going to make their rules available; however, they were going to be accessible online. They could not be printed off. And, more importantly, if you are a merchant and getting these rules like that, you had to sign a non-

disclosure agreement that you could not share them with anybody else. That does not seem like full—

Chairman SPECTER. Is that true, Mr. Floum, a non- disclosure agreement?

Mr. FLOUM. That is correct, Mr. Chairman. Our rules—

Chairman SPECTER. Why?

Mr. FLOUM. Our rules govern the operation of our 14,000 member banks. They address those banks and what those banks are supposed to do to participate in the system.

Chairman SPECTER. Could they disclose them to the Senate Judiciary Committee?

Mr. FLOUM. Yes, of course, and we will be happy to make those available. However, the rules, you need to understand—

Chairman SPECTER. Make them available to the Committee. Mr. Peirez, we can show them then to Mr. Cannon.

Mr. FLOUM. We will, Mr. Chairman.

Chairman SPECTER. Senator Leahy?

Senator LEAHY. Mr. Chairman, your last question was the only question I was going to ask. I like the answer. I have no further questions.

Chairman SPECTER. What is the projection as to Senator Durbin's return?

[Pause.]

Chairman SPECTER. Senator Kyl, do you have any further questions?

Senator KYL. No, Mr. Chairman.

Chairman SPECTER. Senator Durbin will be submitting questions for the record. Thank you very much, Ms. Miller, Mr. Douglass, Mr. Floum, Mr. Peirez, Mr. Muris, and Mr. Cannon. This is a very important subject, and I think that we have learned a good bit about it, notwithstanding its complexity.

That concludes our hearing.

[Whereupon, at 10:54 a.m., the Committee was adjourned.]

[Questions and answers and submissions for the record follow.]

[Additional material is being retained in the Committee files.]

QUESTIONS AND ANSWERS

CONSTANTINE | CANNON

W. Stephen Cannon
Attorney at Law
202-204-3502
scannon@constantinecannon.com

NEW YORK | WASHINGTON

August 28, 2006

BY HAND

Senator Arlen Specter
Chairman
U.S. Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Re: Questions from July 19, 2006 Hearing

Dear Chairman Specter:

Thank you for the opportunity to testify before the Committee on the Judiciary on the issue of credit card interchange fees. I have enclosed my answers to the follow-up written questions from you and Senators Grassley and DeWine.

Please do not hesitate to contact me if you or your colleagues have any further questions.

Sincerely,

W. Stephen Cannon

Enclosure

80272.1

Responses to Written Questions Posed to W. Stephen Cannon

"Credit Card Interchange Fees: Antitrust Concerns?"
A Hearing before the U.S. Senate Committee on the Judiciary
July 19, 2006

Question 1 from Chairman Specter

The credit card companies will not allow merchants to charge customers that use a credit card an additional fee, or surcharge. Do you think this rule constitutes an anticompetitive practice? Do you think that allowing surcharges would encourage competition among credit card companies?

Response to Question 1 from Chairman Specter

The MPC believes that the card associations' "no surcharge" rule is a part of their anticompetitive scheme to fix interchange fees. This compelled lack of transparency reinforces the card associations' price fixing efforts. Specifically, the card associations ensure that consumers (*i.e.*, card holders) deciding which form of payment to use remain ignorant of the supra-competitive costs of using their Visa or MasterCard card by preventing merchants from imposing a surcharge on card purchases that reflect the interchange fees charged to the merchant.

The combination of interchange fees and no-surcharge rules distorts price signals regarding use and thus the nature of competition between payment systems. As summarized by the head of Australia's Reserve Bank: "For cardholders, the price signal they received was that credit card transactions were free, or could even result in receiving a payment in the form of 'points.' ... Merchants, on the other hand, received a signal that the credit card was the most expensive way of making a payment.... But merchants had no power to influence the method of payment for the transaction—for that was in the hands of the cardholder. Thus, the incentives in the system were designed to encourage ... the form of payment that was the most expensive from the perspective of society as a whole. ... But of course the story does not stop here. Ultimately, higher merchant costs flow through into higher prices for the customers of those merchants. This is a cost borne by all consumers whether they use credit cards or not."

Importantly, fees may vary by brand association, type of card (debit or credit), and benefit level (*e.g.*, Visa's Signature brand and MasterCard's World Points, as well as "business" cards) may incur a higher interchange fee for many types of purchases. Hence a rule allowing for a single "cash" discount that does not allow the merchant to reflect the higher fees for a particular type of card may have limited practical value.

With regard to your second question, allowing surcharges may help encourage competition among credit card companies, but eliminating just this one part of the card

associations' price-fixing scheme likely would not be sufficient to produce a competitive marketplace. Elimination of the rest of the anticompetitive scheme – including the actual price fixing of the interchange fee by competing member banks – is also necessary to create competition. Because the freedom of participants to set any price they wish (including imposing surcharges or offering discounts) is a hallmark of competitive markets, the denial of this freedom with respect to credit cards is further evidence of the absence of competition in that market.

Question 2 from Chairman Specter

For years, Visa and MasterCard prevented banks from issuing Discover and American Express Cards, but an antitrust suit by the Justice Department put an end to that conduct. Why do you think that American Express and Discover have not begun to compete to have banks issue their cards?

Response to Question 2 from Chairman Specter

It is correct that the Justice Department successfully challenged Visa's and MasterCard's exclusionary rules "which prohibit[ed] members of their networks from issuing Amex and Discover cards." *United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 237 (2d Cir. 2003). The Second Circuit affirmed the lower court's holding that Visa and MasterCard violated antitrust law by using these exclusionary rules to "effectively foreclose[Amex and Discover] from the business of issuing cards through banks." *Id.* at 237. "Since [Visa's and MasterCard's] exclusionary rules undeniably reduce output and harm consumer welfare, and defendants have offered no persuasive procompetitive justification for them, these rules constitute agreements that unreasonably restrain interstate commerce in violation of Section 1 of the Sherman Act." *Visa U.S.A., Inc.*, 163 F.Supp.2d at 406.

It is the MPC's understanding that subsequent to the Supreme Court's denial of the card associations' petition for a writ of certiorari in October 2004, American Express and Discover have, in fact, begun to compete to have banks issue their cards. American Express has entered into deals with issuers such as Citibank, Bank of America, GE Consumer Finance to issue its cards. Similarly, Discover has entered into deals with issuers including Alliance Data, First Bank & Trust, HSBC Metris, CompuCredit, and GE Consumer Finance. For your consideration, we have attached press releases on these developments.

Please note that Constantine Cannon represents Discover in litigation against Visa and MasterCard.

Question 3 from Chairman Specter

MasterCard has argued that its IPO eliminates any doubt as to the propriety of its decision making with regard to interchange fees under antitrust law. You've argued that the IPO preserved the ability of MasterCard's member banks to collude in setting those fees. It is my understanding that if the member banks engaged in such collusion under MasterCard's current ownership structure, they would not be protected by the Supreme Court's decision in *Texaco v. Dagher*. Assuming they do not engage in such overt collusion, can you explain how MasterCard's structure still raises antitrust concerns?

Response to Question 3 from Chairman Specter

The MPC believes that even subsequent to the IPO, MasterCard's structure raises antitrust concerns. MasterCard's recent reorganization is a change in form, not substance: collective price-fixing continues. The antitrust laws recognize a hub-and-spoke form of conspiracy in which a central agent manages a cartel even if the conspirators do not expressly agree with each other to go along with the "hub's" plan. The case is strongest where there is an agreement among members along the "rim" to utilize the hub. This is precisely the case with the MasterCard reorganization.

Additionally, by agreeing to the reorganization based on the representation that existing agreements such as the interchange fee mechanism would continue, the member banks have agreed to use the services of MasterCard, Inc. as manager of their existing interchange fee cartel arrangement. Moreover, when the MasterCard members agreed to designate MasterCard, Inc., as the ongoing manager of the MasterCard system, they had every reason to believe that its board would operate in their collective best interest as cartel agent: the member banks would remain significant MasterCard shareholders with a collective 44 percent equity interest (plus a 10 percent equity and 18 percent voting interest in a "MasterCard Foundation," with restrictions on the aggregate accumulation of stock by outside parties), they would appoint members to the board with certain voting rights, and they would remain MasterCard's only customers—and MasterCard is dependent on their customer-members' goodwill toward MasterCard. *See* MasterCard Incorporated, SEC Form S-1, Amendment No. 8 at 6-7, 30 (May 23, 2006).

As MasterCard put it, "We are, and will continue to be, significantly dependent on our relationships with our [member banks]...." *Id.* at 21. Indeed, the five largest MasterCard member banks provided 34 percent of MasterCard Inc.'s revenue as of early 2006. *Id.* at 20. And, of course, a consideration for those large issuers remaining in the MasterCard system could be the level of interchange fees paid to them in comparison with, for example, Visa. Thus, even an "independent" MasterCard board could be expected to assume the best interests of all MasterCard shareholders would result from setting interchange fees at levels that are in the collective best interest of issuing banks, particularly MasterCard's dominant issuers. And, as the saying goes the proof of the pudding is in the eating: Since the IPO, MasterCard's interchange rates and rules have not changed. The price fixing continues unabated.

Finally, seemingly benign rules such as "honor all issuers" continue to be imposed post-IPO as part of an ongoing scheme that (i) precludes banks from freely competing on the basis of interchange fees and (ii) blocks the transparency needed for merchants and consumers to recognize the differences in the costs of using different payment options and to base their decisions on these cost differences. While MasterCard (and Visa) can offer outdated historical justifications for these rules, such arguments are no longer valid today, and unless changed these rules will perpetuate the non-competitive outcomes in this market even subsequent to the MasterCard IPO.

I would also like to address your assumption that "if the member banks engaged in [overt] collusion under MasterCard's current ownership structure, they would not be protected by the Supreme Court's decision in *Texaco v. Dagher*." MPC agrees that *Dagher* should not be read to immunize such overt collusion. Unfortunately, however, MPC believes that Supreme Court's decision in *Texaco v. Dagher* may be interpreted as supporting Visa's novel legal position that price fixing by competitors participating in an otherwise legitimate joint venture is per se legal. *See Texaco Inc. v. Dagher*, 126 S.Ct. 1276 (2006).

Visa's position appears to be that price fixing by competitors participating in an otherwise legitimate joint venture is per se legal. Specifically, Visa believes that "[a] joint venture's pricing of things it sells . . . is not an appropriate subject of antitrust inquiry at all" and that "there is no legal or economic basis for applying Section 1 to the pricing decisions of a production or marketing joint venture." Brief of Visa U.S.A. Inc. et al. as Amicus Curiae Supporting Petitioners, *Texaco Inc. v. Dagher*, 126 S.Ct. 1276 (2006), at 17. According to Visa, subjecting the decisions of a joint venture to "antitrust scrutiny – even under the rule of reason – undermines the utility of joint ventures as a form of industrial organization." *Id.* at 3. Not surprisingly, Visa argues that price fixing by competitors participating in a production and marketing joint venture "presents no Section 1 issue under the ancillary restraints doctrine" and has "no effect on competition in any manner relevant to Section 1." *Id.* at 6, 29.

Accordingly, the Visa and MasterCard joint ventures and their members can be expected to use the Supreme Court's *Dagher* opinion in pending class action (as well as any future) litigation challenging its member banks' price fixing of interchange fees. If these arguments are accepted, such price fixing by competing banks will be immune from antitrust challenge. For these reasons, the MPC believes Congress should clarify the illegality of price fixing by competitors participating in a joint venture, generally, as well as examine the price fixing of interchange fees by competing member banks participating in the Visa and MasterCard joint ventures as a specific case study.

Question 1 from Senator Grassley

Europe has looked at the interchange fee from an antitrust perspective. Can you tell me what they have done with regard to interchange fees? What is the impact that it has had?

Response to Question 1 from Senator Grassley

The European Commission has taken several steps regarding interchange fees. In 2002, the Competition Directorate of the European Commission ruled that Visa's collectively-set interchange fees for international transactions within the European Union violated the EU's competition statutes. In particular, the EC found that Visa's interchange fees were set at an inappropriately high level under a mechanism that permitted members to set the interchange fees "at any level they choose, without any objective criteria and in particular regardless of the actual cost of providing the specific services in question." The EC settled the matter by allowing Visa to establish interchange fees set on the basis of specified cost categories. Visa's international interchange fees in Europe have operated in accordance with this settlement since that time. The settlement agreement is currently under review for extension beyond 2007. The European Commission also is currently investigating interchange fees charged by MasterCard for cross-border card transactions and some intra-country transactions.

As a result of the EC's 2002 settlement with Visa, credit card interchange rates in Europe fell significantly, from about 1.0 percent, to less than .8 percent (according to the Federal Reserve Bank of Kansas City). In its April 2006 study of European interchange fees, the EC stated that its 2002 Visa decision "fixed the underlying cost components for consumer card interchange fees and obliged Visa to conduct an in depth study to justify the level of each of the costs.... This appears to have had the effect of reducing Visa cross-border interchange rates. MasterCard cross-border rates remained unregulated, which allowed the network to keep interchange fees significantly above the rates for Visa."

In September 2005, the UK's Office of Fair Trading found that a prior MasterCard interchange fee mechanism violated both UK and European competition laws. However, in June of this year the OFT stated it would concentrate its resources on the currently existing MasterCard and Visa interchange fee mechanisms after a UK court set aside an OFT decision dealing with an interchange fee mechanism that was no longer being used by MasterCard.

In April 2005, the Spanish Competition Tribunal held the interchange fee mechanisms of the three Spanish card processing systems violate Spanish competition laws. In December 2005, the processors agreed to change the manner in which they set interchange fees and the Competition Tribunal is currently reviewing the revised interchange fee mechanism. MasterCard has stated that the proposed revisions "could have a material impact on MasterCard's business in Spain."

Question 2 from Senator Grassley

Have other countries looked at the interchange fee issue? If so, what impact has that had?

Response to Question 2 from Senator Grassley

As I discussed in my prepared testimony, in 2000, the Australian Competition and Consumer Commission ruled that the interchange fee mechanisms used by Visa and MasterCard violated that country's antitrust laws. However, the card networks failed to reach an agreement on remedies with the Competition Commission and, in March 2001, that agency's head requested that the Australian central bank directly regulate interchange fees, as it was authorized to do under Australian law. In response, the central bank limited interchange rates for credit cards to recovery of defined costs, effective November 2003; rules for debit card interchange fees will come into effect later this year.

According to the Australian central bank, the average interchange fees in the credit card system declined from .95 percent of a transaction's value prior to the rules, to .54 percent after. The resulting discount charged merchants fell from 1.40 percent to .92 percent. In contrast, according to the Nilson Report, Visa's average US merchant discount fee was 2.19 percent in 2005.

A key benefit of this interchange fee reduction in Australia was to reduce the subsidies from merchants and their customers that supported the marketing costs of credit cards, including "rewards." As a result, card issuers were forced to compete through lower prices to cardholders, e.g., interest rates, rather than on higher reward levels. Australian consumers thus had a choice of card-types: lower rewards with lower interest rates, or higher rewards with higher interest rates. As a key official of the Australian central bank testified to a Parliamentary committee earlier this year, the reduction of interchange fees resulted in banks focusing on the interest rate-sensitive segment of the consumer marketplace:

> The credit card business was very profitable and the banks were focusing their competitive efforts on giving reward points to card holders. The idea that you would go and compete for credit card customers by lowering an interest rate seemed foreign to many financial institutions. What they wanted to do was attract people by offering a very generous reward scheme. That was where the competition in the credit card industry reflected itself, not on interest rates. But, since we have seen the lower interchange fees come into existence, we have seen the competitive dynamics realign themselves and people are now focusing on that segment of the market, whereas previously that was not the case.[1]

[1] Testimony of Dr. Philip Lowe, Assistant Governor, Reserve Bank of Australia, Official Committee Hansard, House of Representatives Standing Committee on Economics, Finance, and Public Administration, at 51 (May 16, 2006).

This new focus has resulted in an increased number of consumer applications for credit cards, as well as greater charge volumes, as consumers realized they were able to carry balances at lower interest rates. *See, e.g.*, "Rates Fall on Credit Cards," *The Australian* (February 14, 2006) ("Australians have never had easier access to a credit card with banks undercutting each other in the battle for the consumer dollar"); "Big rush for new credit cards," *The Australian* (January 25, 2006).

Question 3 from Senator Grassley

Why can't merchants advertise to their customers at the point of sale both the price a customer would pay with a credit card and the price a customer would pay with cash? Do the interchange fee rules prohibit advertising both cash and credit card prices to consumers? Do any other rules or statutes prohibit merchants from advertising both prices?

Response to Question 3 from Senator Grassley

A full answer to this question requires an understanding of the card associations' operating rules, which I have not yet been able to see. However, it is important to understand that the card associations seem to define a "cash" discount in a very restrictive manner, preventing merchants from fully reflecting differences of the cost of various payment mechanisms in their retail prices. For example, Visa's 2005 summary procedures for merchants states:

> Always treat Visa transactions like any other transaction; that is, you may not impose any surcharge on a Visa transaction. You may, however, offer a discount for cash transactions, provided that the offer is clearly disclosed to customers and the cash price is presented as a discount from *the standard price charged for all other forms of payment.* (Emphasis added.)

Interchange fees vary by brand association, type of card (debit or credit), and benefit level. In particular, Visa's "Signature" brand and MasterCard's "World" brand, as well as "business" cards, may incur a higher interchange fee for many types of purchases. Hence, a rule permitting only a single "cash" discount does not allow the merchant to reflect the higher fees for a particular type of card in prices charged to holders of those cards. In effect, this collectively-set Visa rule requires a merchant to use the same price in accepting a Visa credit card as in accepting MasterCard, American Express, or Discover credit cards, or any type of debit card—a form of compelled retail pricing uniformity among competing payment mechanisms that is hard to justify in a competitive marketplace.

Finally, I have no particular knowledge regarding statutes affecting the posting of cash discounts and will defer to Bill Douglass's response to your question to him on this subject.

Question 1 from Senator DeWine

We have heard from merchants, including some of the witnesses for this hearing, that Visa's and MasterCard's interchange fees are above competitive levels. But, at the same time, we have heard that the number of stores that are choosing to accept Visa or MasterCard is increasing. How do you reconcile these facts?

Response to Question 1 from Senator DeWine

Unfortunately, merchants are caught between a rock and a hard place. As discussed previously, anticompetitive conduct by Visa's and MasterCard's competing member banks has resulted in interchange fees above competitive levels. At the same time, however, a merchant faces economic pressure to accept Visa and MasterCard because they have market power both jointly and separately. Given this market power, a merchant would lose significant sales and profits by refusing to accept Visa or MasterCard, especially given the competitive nature of the merchants' business environment. Thus, to the extent merchants are "choosing" to accept Visa or MasterCard, it is a 'Hobson's choice.'

I should note that the existence of Visa's and Mastercard's market power is not mere conjecture, but rather is a consistent finding by federal courts that have examined this industry recently. For example, the Second Circuit held in *United States v. Visa U.S.A., Inc.* that Visa and MasterCard have market power in the market for network services. Following a thirty-four day trial, the *Visa U.S.A.* District Court defined this market as the one in which networks such as Visa and MasterCard "provide the infrastructure and mechanisms through which general purpose card transactions are conducted, including the authorization, settlement, and clearance of transactions." *United States v. Visa U.S.A., Inc.*, 163 F.Supp.2d 322, 338 (S.D.N.Y. 2001). The court also noted that "[m]erchant acceptance of a card brand is also defined and controlled at the system level and the merchant discount rate is established, directly or indirectly, by the networks." *Id.*

"[W]hether considered jointly or separately, [Visa and MasterCard] have market power in this market." *Id.* at 341. Specific evidence supporting this holding was that "Visa members accounted for approximately 47% of the dollar volume of credit and charge card transactions and MasterCard members for approximately 26%." *Id.* Combined, Visa and MasterCard together control over 73% of the volume of transactions on general purpose cards in the United States and approximately 85% of the cards issued. *Id.* In addition to these high market shares, Visa and MasterCard "have demonstrated their power in the network services market by effectively precluding their largest competitor from successfully soliciting any bank as a customer for its network services and brand." *Visa U.S.A.*, 344 F.3d at 240. Based upon these and other facts in the record – *e.g.*, that the market is highly concentrated and there are high barriers to entry – the Second Circuit affirmed the trial court, ruling that Visa and MasterCard "jointly and separately, have power within the market for network services." *Id.* at 239.

In addition to this government case against the Visa and MasterCard joint ventures, there was a private case brought by merchants who also claimed that Visa and MasterCard engaged in anticompetitive conduct in violation of the antitrust laws. In this private action, another court held that "Visa possesses appreciable economic power" in the credit card services market. *In re Visa Check/Mastermoney Antitrust Litigation*, 2003 WL 1712568 at *3 (E.D.N.Y. April 1, 2003). The court noted that the "evidence establishes conclusively that merchants have not switched to other payment devices despite significant increases in the interchange fees on the defendants' credit cards." *Id.* ("there is no cross-elasticity of demand at the merchant level between the defendants' products and all other forms of payment"). In fact, the court pointed out, Visa itself had "adopted this market definition, excluding all forms of payment except credit and charge cards" in a previous case. *Id.* (*citing SCFC ILC, Inc. v. Visa U.S.A., Inc.*, 36 F.3d 958, 966 (10th Cir. 1994) ("Visa stipulated 'the relevant market is the general purpose card market in the United States'")). Finding that Visa's share of the general purpose credit and charge market had ranged from 41% to 47% during 1991-98 and that Visa's share of the credit card market alone was nearly 60%, the court held that Visa "easily qualifie[d] as [having] 'appreciable economic power' for purposes of the per se rule." *Id.* at *4 (citation omitted).

Notably, these recent holdings that Visa and MasterCard wield market power in a relevant antitrust market confirm that a decades-old case finding that Visa did not possess market power in the alleged market for "all payment devices" is no longer relevant. In that 1986 case, *National Bankcard Corporation v. Visa U.S.A., Inc.*, 779 F.2d 592 (11th Cir. 1986), "the court determined that the relevant product market was all payment devices (including cash, checks, and all forms of credit cards) and that VISA did not possess power in that market." *Id.* at 603 (citation omitted). As demonstrated by the analysis relied upon in the more recent Visa cases cited immediately above, twenty years of evolution in payment systems has substantially changed the boundaries of the relevant market. In this current century, "neither consumers nor [Visa and MasterCard] view debit, cash, and checks as reasonably interchangeable with credit cards." *Visa U.S.A., Inc.*, 163 F.Supp.2d at 338 (holding that "general purpose cards constitute a product market"). Accordingly, the findings in *NaBANCO* are irrelevant to any antitrust analysis of today's credit card market.

To reiterate the answer to your question, even though Visa and MasterCard charge interchange fees that are above competitive levels, their market power means a merchant would lose significant sales and profits by refusing to accept their cards. Given this 'Hobson's choice' of paying supra-competitive interchange fees or foregoing a substantial portion of their business altogether, merchants are forced to accept Visa and MasterCard.

August 28, 2006

VIA E-MAIL

Senator Arlen Specter
Chairman
U.S. Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Re: Questions from July 19, 2006 Hearing

Dear Senator Specter:

Thank you for the opportunity to address the Judiciary Committee on the issue of credit and debit card interchange fees. I very much appreciated the discussion and the thoughtful remarks from you and your colleagues. I have enclosed with this letter my answers to the questions that I received as a follow-up to the hearing.

If there is ever any additional information that I can provide on this – or any other – matter, please do not hesitate to let me know.

Respectfully,

Bill Douglass

Enclosure

325 E. Forest Avenue, Box 1124 • Sherman, Texas 75091 • 903-893-1181 • FAX 903-892-8783

Question from Senator DeWine: *There are still stores that do not take credit cards, and some accept only Discover, American Express, or some other card, including their own cards – and don't accept Visa or MasterCard. If Visa and MasterCard charge interchange fees that you think are too high, why can't you switch to accepting only other cards?*

Answer: The merchants that do not accept Visa and MasterCard are few and far between. The courts have found that Visa and MasterCard have market power and I can tell you from experience that they do. Merchant acceptance of Visa/MasterCard is [well over 90 percent]. If I don't accept their cards I will lose business. The number of consumers who use Discover and American Express are tiny compared to Visa and MasterCard. With nearly 80 percent of the market, Visa and MasterCard are just too dominant for me to stop taking their cards.

Question from Senator DeWine: *We have heard from merchants, including some of the witnesses for this hearing, that Visa's and MasterCard's interchange fees are above competitive levels. But, at the same time, we have heard that the number of stores that are choosing to accept Visa or MasterCard is increasing. How do you reconcile these facts?*

Answer: Merchants have no choice but to accept Visa and MasterCard. Because of the market power of those two card associations, merchant acceptance of their products will continue to increase. Unfortunately, in the broken market of interchange fees, these associations only compete in one way – to raise their interchange fees in order to attract banks to issue more of their cards. This is directly the opposite of the competitive dynamics in healthy markets and consumers are unaware of the inflationary pressure this puts on the price of everything they buy. The antitrust and other fundamental problems with this system have made it such that there is no competition. This market must be fixed so that it can function properly.

Question from Chairman Specter: *In your written testimony, you state that "member banks must agree to charge the same interchange rates." What is your basis for this statement? Do you believe it would make a difference if Visa and MasterCard member banks could charge different rates? If not, how else would you suggest injecting competition into the market?*

Answer: There are several sources for this statement, but perhaps the most emphatic statement on this point was made by Tim Muris when he testified on behalf of the Electronic Payments Coalition before the Commerce, Trade and Consumer Protection Subcommittee of the House Energy and Commerce Committee on February 14, 2006. Both Visa and MasterCard are members of the Electronic Payments Coalition. In both his written and oral testimony at that hearing, Mr. Muris stated not only that Visa and MasterCard fix the interchange fee to be charged by all member banks, but that a centrally set fee was "essential" to the operation of the system. Without it, he argued that the entire system would be at risk because certain issuers may "hold-up" the system by demanding higher fees. Mr. Muris noted that Visa first adopted a fixed fee in 1970. He did not state when MasterCard first used a fixed fee.

While Mr. Muris argues that a fixed fee is essential, it is not clear that is the case and even he notes that reasonableness can never be a defense to price-fixing. It is clear that this price-fixing needs to stop. It is less clear how to rework the current system to inject competition into it. Part of the problem currently is that a competitive system cannot exist without information. Visa and MasterCard keep their rules and the full schedule of their rates secret and that makes it difficult for merchants and consumers to act in ways that might bring about some form of price competition. While we need to know more of the facts about the system to come to the right solution – and Visa and MasterCard's agreement to provide the Committee with their full operating rules may aid this process – making more information available is one place to start.

Question from Chairman Specter: *MasterCard has argued that its IPO eliminated the antitrust problems that you testified to by prohibiting its member banks from owning voting stock. Can you explain why you disagree in more detail?*

Answer: The bank members of MasterCard retain effective control of the organization in spite of the IPO. The new class of stock issued to member banks allows those member banks to exercise veto power over major business decisions of MasterCard. In addition, the limitations on a purchaser's ownership interest in MasterCard stock will keep any new investor from being able to control the direction of the organization. These and other provisions of the IPO along with the current forces pushing interchange fees higher will mean that member banks will continue to exercise effective control of the organization. The bottom line is that the IPO does not in any way solve the antitrust problems with interchange fees.

Question from Chairman Specter: *You testified that you would not surcharge your customers, but do you agree with Visa and MasterCard's restrictive rules regarding merchant pricing? Do you think those should change?*

Answer: While my experience is that surcharging probably would not be an effective strategy for my particular business, I do not think that Visa and MasterCard should dictate the way that merchants price their goods and services. Cash discounts and surcharges may be an effective way for some merchants to let their customers know the costs that are associated with card acceptance. If that works for some businesses, then they ought to be able to do it. The Visa/MasterCard rules restricting this kind of pricing information from being part of the consideration for purchasers is wrong and is part of the reason why this is a broken market. These restrictions certainly should not exist.

Question from Senator Grassley: *Many retailers have complained about a lack of transparency in many aspects of the credit card interchange fee operation. Among other things, you have alleged that the Visa and MasterCard interchange rules are hidden – that is, only synopses are made available to the merchants, the appropriate federal regulatory agency, and the public. What do you think of the credit card companies' original proposal to make available copies of the rules only to those who agree not to discuss them?*

Answer: This proposal by Visa is not a serious attempt to address retailers' concerns. Requiring me to sign a non-disclosure agreement (or gag order) if I view the rules will not allow

me to make a realistic assessment of my rights and where I stand. Typically, I rely on my trade association, the National Association of Convenience Stores (NACS), to help me work through these types of situations. Trade associations may send out summaries or advisories or have meetings on the subject that allow retailers to ask questions. None of this will be possible if Visa's gag order is in place. In fact, and perhaps this is the point, if I were to sign such a gag order then I would not be able to discuss the rules with this Committee or my Representatives in Congress. That clearly is not in the public interest.

Question from Senator Grassley: *Why can't gasoline distributors advertise at service stations both the price a customer would pay if using a credit card and the price a customer would pay if using cash? Do the interchange fee rules prohibit advertising both cash and credit card prices to consumers? Do any other rules or statutes prohibit you from advertising both prices? I would think that with gasoline prices at record highs, customers would welcome any savings they could get when they buy gas at the pump.*

Answer: There are several problems that Visa and MasterCard impose with respect to advertising prices. Most importantly, they require that merchants most prominently advertise the full, credit card price for their products. The effect of this rule in my industry is dramatic. Consumers driving by a motor fuel outlet have a limited time to observe the prices. Even if I post a smaller sign indicating the cash discount price, many will not see it and will not realize the potential savings that I am offering. This rule serves to both hide credit card costs within the price of the product and hamper any attempts to discount for cash. In addition to that, banks have instructed merchants that if they want to discount for cash they need to separately post the cash price for each product as opposed to, for example, posting a sign at the register or on the pump stating that all products receive a certain percentage or dollar discount for the use of cash. This requirement can impose large administrative costs on merchants who want to discount for cash. Posting two sets of prices – cash and credit – for three grades of gasoline is one thing, but doing that for every item inside the store is just too difficult to work. I would also note that while Mr. Peirez said during the hearing that the operating rules did not impose this requirement, at least some Visa and MasterCard member banks believe otherwise and have imposed this requirement on merchants. Situations like this are another reason why merchants need the rules and need to be able to discuss them to protect the full extent of their ability to run their business.

The interaction of Visa's and MasterCard's rules with state pricing laws can also be problematic for merchants. Some states require pricing on individual items so that every item on a shelf would need both the credit card price and the cash price. Posting two prices on the shelf would be very, very difficult for many retailers, but putting two prices on every individual item would be even more burdensome. In sum, the Visa and MasterCard rules that require posting the card price most prominently causes multiple difficulties and makes the merchant's legal right to discount for cash ineffective for most retailers.

Joshua R. Floum
Executive Vice President
General Counsel & Secretary
VISA USA Legal

August 28, 2006

The Honorable Arlen Specter
Chairman, Senate Committee on the Judiciary
United States Senate
Washington, DC 20510

The Honorable Patrick Leahy
Ranking Member, Senate Committee on the Judiciary
United States Senate
Washington, DC 20510

Re: Senate Judiciary Committee July 19 hearing on "Credit Card Interchange Rates: Antitrust Concerns?"

Dear Chairman Specter and Ranking Member Leahy:

Thank you again for the opportunity to appear before the Senate Judiciary Committee to testify on interchange and related matters. Visa U.S.A. Inc. ("Visa") believes strongly in the value and benefits of electronic payments to consumers and merchants, and we appreciated the chance to share with the Committee the underlying mechanisms that ensure a competitive, dynamic, and growing payments marketplace.

Electronic payments are one of the most important innovations in the modern economy. Over the last 40 years, they have provided consumers with ever-improving convenience, flexibility, and speed, while helping merchants of all sizes process more and more transactions with greater ease and efficiency. And, electronic payments have helped to open entirely new business opportunities such as e-commerce.

We recognize the inherent challenges in describing the complexities of our business and the interchange mechanism. However, it's important to point out that how Visa sets interchange is similar to how many, if not most, businesses (perhaps even retailers) determine pricing for the products and services they sell. Interchange represents a careful balancing of the costs of supply and the value of demand. In the case of Visa, there are two "end users," cardholders and merchants, and the supply and demand characteristics of both of these end users must be taken into account when setting the "wholesale" rates between the banks, which acquire for merchants on the one hand, and issue cards to consumers, on the other. An analogy would be when a consumer shops, that consumer is paying a retail price for the merchandise he or she buys. The wholesale price the store paid for that product is set by the manufacturer and the retailer

VISA USA INC.
Post Office Box 194607
San Francisco, CA 94119-4607
U.S.A.

Phone: 41-932-2244
Fax: 650-554-3711

is under no obligation to share that price with the consumer. This latitude allows retailers to compete with one another by marking wholesale prices up or down, offering services and products in combination with one another, holding sales and special promotions and the like, and still make a profit.

Competition is fundamentally "baked" into the process of setting interchange. The reason for this is that not only is interchange a tool that allows Visa to compete for the issuance of cards by banks and thereby grow consumer use of efficient, secure, and reliable electronic payments, it is equally used to compete for the acceptance of cards by merchants. If interchange is set too low, fewer Visa cards may be issued by banks and consumer usage is curtailed. If interchange is set too high, merchant banks will be unable to contract with merchants to accept our products and both merchants and cardholders alike will drop out of the system. This balancing act requires the competitive setting of interchange.

It is also important to recognize that merchants both large and small have a role in determining their payment costs, and we are always open to discussing the many options at their disposal. For example, retailers are free to steer consumers to other forms of payment, they can offer consumers cash discounts, and, of course, they can choose not to accept Visa if it doesn't make sense for their business. Additionally, Visa has a track record of working with retailers in specialized categories – from utilities to fuel – to develop a pricing model that works for them while driving volume to our system. Having said that, and to address the focus of your hearing, a 2005 study by the Aite consulting group found that the cost to merchants of accepting credit card payments, in particular, is lower in the United States than in most developed countries.

We know that the Committee is aware that Visa has a dispute with some large retailers and national chain stores who are seeking government price controls on interchange and the ability to surcharge consumers. However, it would be a disservice to the Committee to suggest that this dispute accurately reflects the relationship we have with the millions of merchants we serve. Merchants are important stakeholders within the Visa system, and we will continue to work hard to earn their business, while maintaining the convenient, reliable, and secure payments network that helps drive their growth and security. We believe the value Visa delivers to retailers is a key reason why, in 2005, Visa increased the number of businesses who accept our cards by over one million outlets, bringing total card acceptance to over 6 million outlets.

Attached are my responses to the specific follow-up questions from your Committee. Please let me know if I may be of any further assistance. We look forward to maintaining an ongoing dialogue with the Committee on this and other issues.

Sincerely,

/S/

Joshua R. Floum

Enclosures

Answers to Written Questions
"Credit Card Interchange Fees: Antitrust Concerns?"
A Hearing before the Senate Judiciary Committee
July 19, 2006

Questions from Senator Specter:

1. It seems clear to me that MasterCard and Visa have market power, and the courts seem to agree with me on that. Your member banks overlap almost completely, and together you have roughly a 75 percent market share. Can you explain to me why—other than that it has resulted in over $30 billion dollars in revenues—interchange fees are a percentage of every purchase? As Mrs. Miller has testified, it seems to me that the cost of processing the payment is the same, regardless of the amount.

Answer to Question 1:

Visa believes that the guiding analysis here is to be found in *National Bancard Corp. v. Visa U.S.A., Inc.*, 779 F.2d 592 (11th Cir. 1986), a case where the trial and appeals courts expressly considered whether interchange is unlawful price-fixing. Those courts found that interchange, far from being unlawful, in fact promotes competition. The courts held that interchange is both fair and necessary to the operation of a payment card system. Further, the courts recognized that Visa competes with a broad variety of payment methods – including cash and checks – for the loyalty of merchants and consumers. Visa continues to compete vigorously with cash and checks, and in fact an array of new market entrants such as PayPal, Debitman, Google Checkout and others create more fierce competition for every payment transaction every day.

Although one court recently found that MasterCard and Visa have market power, it is important to emphasize that the market at issue in that case was not consumer or merchant use of payments. Instead, the court's finding in *United States v. Visa U.S.A. Inc.*, 344 F.3d 229 (2d Cir. 2003), was that Visa and MasterCard together had market power in an alleged market for "general purpose network services" to banks and processors. Although Visa disagrees, the finding should be understood within the context of that litigation – litigation in which banks were the customers at issue. Here, this Committee is considering the effect of interchange fees on merchants and cardholders, and that calls for a different analysis.

If a company unlawfully exercises market power, one would expect output to be restricted and prices to be set at unreasonably high levels. This is far from the case with Visa, as more and more cardholders and merchants use the services provided by Visa's member banks and Visa's interchange and its

member banks' merchant discount rates are lower than its smaller competitor American Express.

It is important to emphasize as well that interchange fees are not charged to merchants or cardholders and are not revenues received by Visa. Rather, they are fees which are paid by the merchant's bank (the "acquirer") to the cardholder's bank (the "issuer"). Just as for any other service provider or manufacturer, these rates reflect not only the costs of communicating transaction information, but also the value to stakeholders of providing a constantly improving and efficient system. Visa uses interchange to encourage members to grow and invest in the system, to the benefit of both merchants and cardholders. Increased cardholder use means increased volume and profit for merchants, and increased acceptance means increased value for cardholders. Interchange must strike the balance that accomplishes both of these goals. If acquirers charge too much to merchants, acceptance would be discouraged and the system as a whole would suffer. And, if issuers charge cardholders too much, use would be discouraged and, again, the system as a whole would suffer. Visa uses the interchange fee to incent innovation, product development and use, data security, cardholder convenience and the increased use of more efficient payment devices in lieu of cash and checks.

2. Retailers have said that they do not get a copy of the full schedule of interchange fee rates charged on different transactions. How can you justify not letting your customers see the prices they are paying for the service you provide?

Answer to Question 2:

Retailers do know, and always have known, the price they pay to accept Visa cards. Retailers are not customers of Visa nor do they pay fees to Visa. Instead, they negotiate their cost of acceptance directly with their bank; this price is known as the "merchant discount." Retailers are fully aware of the merchant discount they pay.

Interchange, on the other hand, is a fee paid from acquirers, the merchant's bank, to issuers, the cardholder's bank, within the Visa system. It is, in essence, the "wholesale cost" of a payment card transaction. As I testified, neither the Macy's at Pentagon City nor for that matter any gas station or other retailer posts their wholesale costs, only their retail prices—because this is what the consumer pays. Unlike interest rates or late fees charged by banks to consumers, interchange fees are not paid by merchants or cardholders. They are inter-bank wholesale rates, which the merchant's bank can either mark up or down, and to require disclosure to merchants or cardholders would be analogous to requiring gas stations to post what they pay wholesale for fuel from their suppliers.

3. Could you describe in detail the process Visa uses to establish interchange fees for its various card products? What costs are included? What costs are excluded?

Answer to Question 3:

Interchange is a transfer of value between the merchant's bank and the cardholder's bank involved in a particular transaction. Like any other value-based model, interchange reflects not only the costs of communicating transaction information, but also the value to stakeholders of providing a constantly improving and efficient system. All participants benefit as the system expands and becomes more efficient. Visa uses interchange to reflect this value between bank participants, and to encourage members to grow and invest in the system, to the benefit of merchants and cardholders.

Visa manages its interchange rates to reflect unique product attributes, the modes of processing a payment, and the different dynamics of various merchant segments. On the product side, Visa has a separate set of interchange rates for Visa's debit product from the interchange rates that apply to its consumer credit products, and both are different from the interchange rates applied to Visa's commercial products. In all cases, interchange reflects the costs of providing these various product types, the value each product type generates for acquirers and merchants, and the level of pricing on competing products and services.

In each case, product-level distinctions in the cost-of-funds, the risk of cardholder default on payment, and other costs of acquiring and servicing consumers are taken into account.

Examples of how Visa has used interchange to achieve its goals of expanding participation in the Visa payment system and strengthen system performance include the following:

- To provide greater cardholder and merchant security on internet transactions, in December 2001 Visa developed its Verified-by-Visa Program. To provide incentives for merchant adoption, Visa provides lower interchange rates on transactions authenticated through the service.
- In October 2003, Visa created the Small Ticket Payment Service to drive further penetration of low dollar transactions in cash-heavy segments. As part of the program, Visa eliminated signature requirements, provided incentive interchange rates, and provided additional merchant protections. These pricing strategies led to the development of wide payments acceptance in, for example, quick-service restaurants.
- Visa also created a utilities program in April 2005, designed to grow the use of Visa for consumer bill payments in that segment. A custom-tailored interchange schedule for this program has led to

the enrollment of more than 4,000 utilities in the program, leading to greater efficiency, security, and payment certainty for these regulated providers.

Visa U.S.A.'s Independent Directors are responsible for managing Visa's interchange rates that apply to the U.S. marketplace. When evaluating interchange rates to determine if Visa is competing effectively and meeting its goals to grow system participation and payment volume, Visa looks at data from the marketplace, including rates of transaction and sales volume growth in key merchant segments, and the product, merchant, and risk attributes described above.

4. Visa introduced a higher fee structure for its premium Visa Signature card on April 1, 2005, the same day that MasterCard introduced a higher fee structure for its premium World card. What process was used to ensure that the higher fees for the premium cards offered by MasterCard and Visa were made effective the same day?

Answer to Question 4:

Visa did not communicate with MasterCard about this pricing decision, and, to the best of my knowledge, it has never communicated with MasterCard about any other pricing decision. To the contrary, Visa competes vigorously with MasterCard and considers its interchange strategies among its most confidential and competitively sensitive information.

Visa's system processes billions of transactions a year virtually flawlessly. In 2005, the system experienced only 72 seconds of "down time." To accomplish this feat, Visa makes sure that all updates to its system are carefully planned and coordinated. Visa, therefore, announces system changes in advance and implements them on a predictable schedule, timed to avoid critical peak transaction seasons. Upgrades are made in April and October of each year. Visa announced its changes to Visa Signature to acquirers on November 19, 2004 and implemented them the following April. Visa did not learn of the MasterCard changes to its World card product until after MasterCard announced its changes in February 2005.

5. Please make a full copy of Visa's operating rules available to the Committee.

Answer to Question 5:

Visa will make a fully copy of its Operating Regulations available to the Committee.

Visa Operating Regulations contain confidential and sensitive information about the Visa system. Securing the Visa system and cardholder information with which we are entrusted is crucial to all stakeholders in our system; therefore, we request that the Committee review our Operating Regulations in confidence.

We also note for the Committee that Visa has recently announced that Visa will make its Operating Regulations available to its merchants. As Visa continues to grow and expand in today's dynamic and competitive marketplace, we are committed to making the organization as transparent as reasonably possible. While Visa's merchant rules guide has been available for over a decade, and it is among the most viewed documents on our web site, some merchants have asked us to provide even more detail. We are responding to this request by sharing Visa's operating regulations with those qualifying merchants and third-party agents who participate in the Visa system. The operating regulations will be available beginning in September 2006 and will be provided under a nondisclosure agreement to protect confidentiality.

Answers to Written Questions
"Credit Card Interchange Fees: Antitrust Concerns?"
A Hearing before the Senate Judiciary Committee
July 19, 2006

Questions from Senator Durbin:

1. On April 1, 2005, Visa introduced a higher fee structure for your premium Visa Signature card. On the same day, MasterCard introduced a higher fee structure for its premium World card. Was this a mere coincidence that your two competing companies introduced higher fees for the two competing products on the same day, or did Visa and MasterCard communicate with each other to plan the timing of the announcement?

Answer to Question 1:

Visa did not communicate with MasterCard about this pricing decision or its timing, and, to the best of my knowledge, it has never communicated with MasterCard about any other pricing decision. To the contrary, Visa competes vigorously with MasterCard and considers its interchange strategies among its most confidential and competitively sensitive information.

The Visa system processes billions of transactions a year virtually flawlessly. Even with this volume and nearly instantaneous transaction time, in 2005 the Visa network experienced only 72 seconds of "down time." Visa makes sure that all updates to its system are carefully planned and coordinated. Visa therefore announces system changes in advance and implements them on a predictable schedule, timed to avoid critical peak transaction seasons. Upgrades are made in April and October of each year. Visa announced its changes to Visa Signature to acquirers on November 19, 2004 and implemented them the following April. Visa did not learn of the MasterCard changes to its World card product until after MasterCard announced its changes in February 2005.

2. At the hearing, one of the merchant witnesses mentioned the problem of "reason code 96," which your company uses to deny gasoline retailers payment on the entire amount of a transaction when the gasoline purchase by a consumer at that station is more than a set amount. Yet, I understand that the retailer is not allowed to set a maximum transaction amount for credit card sales of gasoline under your rules. What is the rationale for this rule? How does Visa alert merchants about this rule and the consequences for violating it? How much in dollars were these chargebacks made to retailers during the past year?

Answer to Question 2:

"Reason code 96" is one of the several examples of Visa's efforts to balance the many interests within a payment system – facilitating the development of new and innovative payment methods on the one hand, while managing the risks of these new opportunities on the other. To support gas stations' efforts to reduce costs and improve customer service, as well as to provide cardholders with a new and easy way to pay for their gas, Visa introduced special procedures that make it possible to use a Visa card at a gasoline pump without ever seeing an attendant (these pumps are known as "Automated Fuel Dispensers" (AFDs)). But, as would be expected, these pumps do create additional risk to the system, and that risk increases with the transaction amount. To manage this risk, Visa limits these transaction amounts to $50 and, in turn, permits the issuer, the cardholder's bank, to "charge back" (refuse payment to) the acquirer, the merchant's bank, where an AFD transaction exceeds $50 and the issuer is unable to honor the transaction. In the Visa system, the acquirer or merchant's bank is responsible for communicating to the merchants rules related to card acceptance, including chargebacks.

Gasoline retailers can set maximum sale amounts at unattended pumps, and Visa understands that many do so. In this way, gasoline retailers, too, can manage their risk. For sales more than $50, retailers can always process them in person at the counter, in which case no limit applies, reflecting the reduced risk of an in-person sale.

Visa can provide the number of chargebacks sent through its system from the cardholder's bank to the merchant's bank, but we do not know what the financial arrangements are between the retailer and its bank. For the last 12 months ending July 2006, only 0.01% of Visa AFD purchase transactions were charged back from the cardholder's bank to the merchant's bank.

3. What would be the effects of Federal Reserve regulation of credit card interchange fees? Would fees increase or decrease if the Fed regulated these fees?

Answer to Question 3:

The effect of Federal Reserve price controls that force interchange rates down would be to shift the cost of supporting card payment systems from merchants to consumers. Visa recognizes that a reduction in interchange could lead to a reduction in retailers' costs – the question, however, is who will bear the cost of their increased profits? Visa suggests to this Committee that ultimately it is consumers that will bear the cost, as the Australian experience tells us. While the Visa system must consider the needs of both merchants and cardholders to survive, merchants have no similar incentive to engage in that balancing. And that it is why cardholders have the most to lose if the balance becomes skewed towards the interests of merchants alone.

Ultimately, Visa believes that allowing free markets to work, rather than government intervention, is the best way to foster competition, drive innovation, and serve consumers. Visa believes that free market competition is working in our industry, and that you can see that every day in our performance. Indeed, unlike firms with market power that restrict output to obtain high prices, Visa has continuously worked to expand the Visa system, increasing the value it creates for both merchants and cardholders so that the Visa card is today accepted and used more than at any time in the past.

Answers to Written Questions
"Credit Card Interchange Fees: Antitrust Concerns?"
A Hearing before the Senate Judiciary Committee
July 19, 2006

Questions from Senator Grassley:

1. How much revenue, per year, is raised because of interchange fees? How much is spent, per year, on making the payment system more efficient and secure?

Answer to Question 1:

Revenue from interchange flows to banks, not Visa. On purchase transactions, interchange fees are paid by financial institutions that sign merchants up for card acceptance to financial institutions that issue cards to cardholders. Visa has more than 10,000 card-issuing banks in the United States, including credit unions, community banks, and thrifts, among others. Together, those financial institutions in 2005 collected some $19 billion in interchange fee revenues on Visa purchase transactions in the United States. These revenues helped fund a wide range of issuer investments, operations, and activities that benefit the Visa system, merchants, and cardholders. Indeed, each and every of Visa's thousands of card-issuing financial institutions must invest in its own security and efficiency controls to manage its own card programs.

Visa realizes its revenue not through interchange, but predominately from fees paid by banks, specifically, separate transaction processing and service fees that it charges its participating member banks. In fiscal year 2005, Visa USA collected some $1.9 billion in net transaction processing and service fees. In this same year, Visa spending on risk management and security, systems development and enhancements, and product and service development was in excess of $500 million. This investment results in a payment system that processes payment transactions virtually instantaneously, and without fault, and fraud detection systems that can spot fraud even before it happens.

2. Who sits on the board that sets the policy and rates for interchange fees?

Answer to Question 2:

Visa U.S.A.'s Independent Directors are responsible for U.S. interchange policy and rates. These directors are not affiliated with any of the banks which pay or receive interchange. They instead come from an array of backgrounds and bring to our company a wealth of diverse experiences and perspectives, including merchant perspectives. Our four Independent Directors are:

- Philip D. DeFeo, who is a managing partner of Lithos Capital Partners LLC. Prior to joining Lithos Capital Partners, Mr. DeFeo served as Chairman and CEO of the Pacific Exchange, Inc., from 1999 to 2005. Mr. DeFeo currently serves as Deputy Chairman of the board of directors of Computershare Investor Services.
- Linda Baker Keene, who has held management positions with a number of consumer-driven companies, including The Gillette Company, The Pillsbury Company, and American Express Financial Advisors. Ms. Keene has served on the board of directors of two public companies, Scholastic, Inc. and Huffy Corporation.
- Jon C. Madonna, who has held prominent positions with Carlson Wagonlit Travel, Travelers Insurance Group, Inc., and KPMG. Mr. Madonna's career with KPMG spanned 28 years, where he held the position of Chairman and CEO. Mr. Madonna has been a member of the boards of directors of Albertson's, Inc., Phelps Dodge Corporation, Tidewater, Inc., and AT&T.
- John A. Swainson, who is the President, CEO, and a member of the board of directors of CA Inc. Prior to joining CA Inc. in 2004, Mr. Swainson spent 26 years with IBM Corporation. Mr. Swainson is a member of the board of directors of the U.S. Chamber of Commerce and Cadence Design Systems, Inc.

Other Visa U.S.A. Board members are:

- William I. Campbell, Senior Advisor to the CEO, J.P. Morgan Chase
- Richard K. Davis, President and CEO, U.S. Bancorp
- Charles T. Doyle, Chairman of the Board, Texas First Bank
- Robert R. Hackney III, Cardservices for Credit Unions
- Benjamin P. Jenkins III, Vice Chairman and President General Bank, Wachovia Corporation
- Bruce R. Lauritzen, Chairman, First National Bank of Omaha
- Peter E. Raskind, Vice Chairman, National City Corporation
- Joseph W. Saunders, President, Card Services, Washington Mutual

- Charles W. Scharf, CEO, Retail Financial Services, J.P. Morgan Chase
- John G. Stumpf, President and COO, Wells Fargo & Company
- James M. Wells III, President and COO, SunTrust Banks, Inc.
- John Philip Coghlan, President and CEO, Visa U.S.A.
- Christopher Rodrigues, President and CEO, Visa International

3. Who makes the decision to increase interchange fees? Have these fees ever been lowered rather than increased?

Answer to Question 3:

As explained above, Visa U.S.A.'s independent directors are responsible for managing U.S. interchange rates.

Interchange rates today are significantly lower than they were when the Visa system was formed, and Visa has reduced interchange fees many times in recent years. For example:

- In April 2005, Visa reduced several of its offline debit rates for transactions at supermarkets and retail stores, effectively reducing the interchange rates on 40% of the sales volume on the Visa check card.
- In October 2003, Visa launched its small ticket payment service, which reduced the interchange rate applied to consumer credit and debit transactions below $15 in seven merchant segments including fast food and other restaurants, movie theaters, and video rental stores.
- In April 2006, Visa expanded its small ticket payment service to an additional seven merchant segments and lowered the rate applied to small ticket consumer debit transactions.
- In April 2005, Visa introduced a new reduced incentive interchange rate applied to transactions in the utility segment.

4. Why do merchants have to sign non-disclosure agreements regarding the interchange fee rules? Why is there not more transparency with respect to interchange operations?

Answer to Question 4:

The interchange fee rules govern only the relationship between acquiring banks and issuing banks; they do not directly impose any obligation on merchants. Merchant obligations toward the Visa system are reflected in the contracts that each individual merchant has with its bank. That said, Visa has long made public those aspects of its operations that most directly affect merchants and cardholders. I am told that, for more than a decade, Visa has

made a merchant rules guide available to merchants, and it is among the most viewed documents on the Visa website.

In addition, recognizing the important role merchants play in the Visa system, Visa has recently taken the step of making almost its entire Operating Regulations available to merchants. Unlike MasterCard, which provides an excerpt of its Operating Regulations to merchants, Visa intends to make all of its rules available, subject only to the omission of information that would raise simply too great of a competitive or security risk to the system. Visa is merely seeking from merchants a commitment – similar to those it has always sought from its members – to respect the confidentiality of the regulations so that the safeness and soundness of the system is protected. It is important to recognize that our rules include information related to issues such as the processing of transactions and card design that must be protected to avoid security risks – risks that have the potential to harm merchants and cardholders as well as Visa.

Answers to Written Questions
"Credit Card Interchange Fees: Antitrust Concerns?"
A Hearing before the Senate Judiciary Committee
July 19, 2006

Questions from Senator DeWine:

1. We heard testimony that interchange fees continue to go up, yet credit card costs, including card processing, borrowing, fraud, and other costs, are reported to have declined. If the credit card industry really is competitive, with decreasing costs and more claimed efficiencies in the credit card payment system, why don't we see interchange fees coming down? Have any interchange fees decreased?

Answer to Question 1:

Interchange is a transfer of value between the acquirer and the issuer involved in a particular transaction. Like any other value-based model, interchange reflects not only the costs of communicating transaction information, but also the value to stakeholders of providing a constantly improving and efficient system. All participants benefit as the system expands and becomes more efficient. Visa uses interchange to reflect this value between bank participants and to encourage members to grow and invest in the system, to the benefit of merchants and cardholders.

Visa manages its interchange rates to reflect unique product attributes, the modes of processing a payment, and the different dynamics of various merchant segments. In all cases, interchange reflects the value each product type generates for acquirers and merchants.

In each case, product-level distinctions in the cost-of-funds, the risk of cardholder default on payment, and other costs of acquiring and servicing consumers are taken into account.

Today, interchange rates are significantly lower than they were when the Visa system was formed – even as the US system has grown to allow more than 6.3 million merchant outlets to conduct business and make sales to more than 500 million cardholders.

Visa has a long history of using lower interchange rates as a tool to expand merchant acceptance and usage, encourage strong system performance, and incent adoption of new Visa products and services. Examples of times Visa has reduced interchange fees in recent years include:

- To provide greater cardholder and merchant security on internet transactions, in December 2001 Visa developed its Verified-by-Visa Program. To provide incentives for merchant adoption, Visa

provides lower interchange rates on transactions authenticated through the service.

- In October 2003, Visa launched its small ticket payment service, which reduced the interchange rate applied to consumer credit and debit transactions below $15 in seven merchant segments including fast food and other restaurants, movie theaters, and video rental stores. In April 2006, Visa expanded this service to an additional seven merchant segments and further lowered the rate applied to small ticket consumer debit transactions.
- In April 2005, Visa reduced several of its offline debit rates for transactions at supermarkets and retail stores, effectively reducing the interchange rates on 40% of the sales volume on the Visa check card.
- Also in April 2005, Visa introduced an incentive interchange rate applied to transactions in the utility segment, to help grow Visa's acceptance and usage in this importance bill pay segment.

2. Issuing banks choose which card to issue in part based on which card will give them more revenues from interchange fees. In other words, credit cards compete over issuing banks by offering higher interchange fees. Because of this, competition seems to push prices up rather than down. On the other hand, to attract cardholders, a credit card company needs to be widely accepted, so it needs to attract merchants to accept the cards. This encourages the card companies to lower interchange fees. How do you balance these two pressures, and how does competition between Visa, MasterCard, American Express, and other cards provide a check on fees?

Answer to Question 2:

Your question strikes at the heart of how the Visa system works, the way competition drives interchange, and how the current payments marketplace leads to efficient use of electronic payments, rapid payments innovation, and the maximization of cardholder and merchant participation in the system.

You are correct that Visa competes with other payment networks for the business of issuing banks, which ensures the cardholder participation that is essential to the value proposition that we offer to merchants. And, at the same time, you are also correct that Visa must compete for merchant acceptance to ensure the merchant participation that is essential to the value proposition that we offer to cardholders.

Interchange is indeed the way we manage these two goals. If Visa set interchange too high, merchant acceptance could drop. If Visa set interchange too low, cardholder use could drop and banks may leave Visa to issue cards on competing networks with higher interchange. When setting interchange, Visa has to conduct a careful analysis that looks at a variety of

factors that have been discussed, but, as you note, one of these factors is always the level of pricing on competing goods and services (which includes an array of payment alternatives, not just competitors like MasterCard and American Express). In this way, competition always acts as a check on interchange. Visa's ability to appeal – through acquirers – to a much broader set of merchants is a key factor in competing against American Express (which is generally priced higher). Similarly, Visa's ability to appeal – through issuers – to the largest number of cardholders is a key factor in competing against Discover (which is generally priced lower). Overall, it is Visa's objective to have the highest level of merchant acceptance and cardholder usage, and striking an appropriate balance in the setting of interchange is central to achieving this objective.

3. Merchants have claimed that when Visa and MasterCard coordinate on setting interchange fees, or set fees collectively, this violates the antitrust laws. In fact, some merchants have brought antitrust suits challenging the way Visa and MasterCard have set their fees. On the other hand, Mr. Muris has testified that their coordination has been reasonable and pro-competitive. Nonetheless, Visa and MasterCard have made changes in the way interchange fees are set. What changes have you made, and do Visa and MasterCard currently coordinate in any way on setting of any fees?

Answer to Question 3:

I am not aware of anything suggesting that Visa has ever coordinated with MasterCard on pricing decisions. Mr. Muris said that coordination within Visa has been reasonable and pro-competitive. He did not speak to coordination between Visa and MasterCard.

Visa has made changes to the setting of interchange, and, as previously described, has also implemented certain decreases in interchange. Nevertheless, some retailers and plaintiffs' attorneys have been driving antitrust challenges against Visa in the courts. Visa disagrees with all of their claims. As discussed at the hearing, every court to rule on the issue to date has held that the setting of interchange is fair and pro-competitive.

In May 2006, Visa U.S.A. added four independent directors to its Board of Directors. These independent directors are solely responsible for reviewing decisions with a direct economic impact on Visa member banks, including the interchange rates that apply to the U.S. marketplace. Interchange has always been set lawfully. Visa believes these directors add value to our Board for a number of additional reasons, including the increased level of diversity and breadth of experience they bring as we move forward in an increasingly competitive marketplace.

August 8, 2006

Senator Arlen Specter
Chairman
United States Senate
Committee on the Judiciary
Washington, DC 20510

Dear Senator Specter,

The hearing transcript is fine with me.

Question 1:

I have not seen anything that says we can be sued. So, by being transparent at least we would be able to see the rules and know what they are.

Question 2:

Do I think Visa and MasterCard interchange rates are too high – why not switch? I couldn't even think about switching. We have been taking these cards for 12+ years, and our customers expect us to. Visa and MasterCard are 80% of the Market – It is not an option not to take them.

Question 3:

How do I reconcile the fact that the number of stores are increasingly taking Visa and MasterCard. We take them because of our custeomers expectations. It is a plastic world out there. More people are carrying the cards so we are swiping them more. More and more purchases are plastic, not cash.

Again, thank you for the chance to testify in front of your Committee. It was an honor to be asked. Please do not hesitate to call me or e-mail me if you have any more questions.

Sincerely,

Kathy Miller
The Elmore Store
Lake Elmore, VT

O'MELVENY & MYERS LLP

BEIJING
BRUSSELS
CENTURY CITY
HONG KONG
LONDON
LOS ANGELES

1625 Eye Street, NW
Washington, D.C. 20006-4001

TELEPHONE (202) 383-5300
FACSIMILE (202) 383-5414
www.omm.com

NEWPORT BEACH
NEW YORK
SAN FRANCISCO
SHANGHAI
SILICON VALLEY
TOKYO

OUR FILE NUMBER

WRITER'S DIRECT DIAL
(202) 383-5350

WRITER'S E-MAIL ADDRESS
tmuris@omm.com

August 28, 2006

The Honorable Arlen Specter
Chairman
Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Attn: Barr Huefner

Re: ***Credit Card Interchange Fees: Antitrust Concerns?***

Dear Chairman Specter:

Thank you very much for the opportunity to address the Senate Judiciary Committee on the important topic of "Credit Card Interchange Fees: Antitrust Concerns?" I feel quite strongly that Congress should not intervene in this very competitive industry, but I recognize that further discussion about interchange may be productive.

I am forwarding my responses to the Committee's follow-up questions. To the extent that I addressed the issues raised in your questions in my testimony, I ask that you incorporate my earlier remarks by reference.

If I can be of further assistance to the Committee on this topic, please do not hesitate to contact me.

Sincerely,

Timothy J. Muris

Timothy J. Muris

Enclosure

"Credit Card Interchange Fees: Antitrust Concerns?"
Hearing Before the Senate Judiciary Committee

SENATOR SPECTER

1. Do you think that the management changes adopted by MasterCard and Visa change the antitrust analysis with respect to interchange fees?

I do not believe that Visa and MasterCard's previous approach to interchange violates the antitrust laws. The changes that the companies have made to their respective corporate form and governance structures, however, do change the analysis. The financial institutions that participate in the Visa and MasterCard networks no longer play a formal role in the setting of interchange rates. Those rates should not, therefore, be seen as the product of agreements among horizontal competitors.

2. The European Commission recently found that the mechanism by which interchange fees are set raises concerns under European competition law. In your opinion, why does this mechanism raise concerns under European law, but not under the U.S. antitrust laws?

The Competition Directorate of the European Commission has undertaken an Article 17 sector inquiry of the retail banking industry, including payment cards. It is important to understand that findings made under Article 17 are only preliminary and do not constitute an infringement decision under Articles 81 and 82. No sanctions may be applied following such an Article 17 inquiry. If the EC is of the view that matters investigated may involve issues under Article 81 and/or Article 82, the EC must initiate a formal proceeding under Article 81 and/or Article 82 and follow the due process established under EC law for infringement proceedings.

The EC has been investigating the payment business for some time, and its most recent public pronouncement did address interchange fees. The EC's primary concerns, however, do not seem to be related to antitrust law or competition policy, at least as we typically understand them in the United States. The EC currently has embarked on an effort to create a single market for various products and services across the various countries of the European Union. In analyzing interchange rates and what merchants pay to accept electronic payment, the EC has observed that rates vary across the member states, and it is considering regulating rates on a community wide basis as a way of forging a single market for electronic payments. Regulated rates, of course, can be expected to have the same effect in Europe that they have had in Australia—namely higher prices for cardholders.

SENATOR DURBIN

1. When you appeared at a hearing on February 15, 2006, before the House Energy and Commerce Committee's Subcommittee on Commerce, Trade, and Consumer Protection, Representative Jan Schakowsky of Illinois asked you whether the operating rules of Visa and MasterCard were publicly available. On at least four different occasions during Representative Schakowsky's question period, she asked you, on behalf of the Electronic Payments Coalition, to provide the Committee with a full copy of the operating rules. At one point in that exchange, you said that those rules were already available on Visa's and MasterCard's websites. Then, you said that you would "go back and ask" Visa and MasterCard to provide rules. Did you ever provide the House Subcommittee with copies of the rules? If so, please explain when you delivered them, and under what conditions. If not, please explain your reasons.

The question of transparency arose several times at the House Energy and Commerce Committee hearing. Representative Schakowsky asked whether I could help the Committee and Mr. Armour get copies of the Operating Regulations of Visa and MasterCard. I indicated in response to her question and a similar question from Representative Stearns that I could not speak for Visa and MasterCard on that question, but that I would raise the issue with them. *The Law and Economics of Interchange Fees: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the H. Comm. on Energy and Commerce*, 109th Cong. 66, 88 (2006).

Following the hearing, I spoke with representatives of MasterCard, and was told that MasterCard posts its Merchant Rules on its website. I understand that MasterCard produced a copy of the document on its website to Representative Schakowsky. I also spoke with representatives of Visa, and learned that Visa posts a guide on its website for merchants that accept Visa cards, which Visa provided to the Committee following the hearing.

Since the hearing, Visa has taken additional steps regarding the general distribution of its Operating Regulations. Historically, Visa has not made them available to anyone but the banks that belong to the association. As Josh Floum, Visa's General Counsel, explained at the Hearing before the Senate Judiciary Committee, the Operating Regulations will be available, subject to certain conditions, to any merchant currently accepting Visa cards that would like to see them.

2. Does Visa or MasterCard require a non-disclosure agreement before anyone is allowed to see these operating rules?

As Visa explained at the Hearing before the Committee, the Operating Regulations will be available, subject to certain conditions, to any merchant currently accepting Visa cards that would like to see them. I understand that MasterCard has posted its Merchant Rules on its website. Visa and MasterCard would be able to offer more specifics regarding disclosure of their rules and regulations.

3. Is it true that card associations' operating rules prohibit a merchant from charging a customer more if they use a credit card instead of cash, but the rules allow merchants to offer a cash discount? If so, what is the rationale for this rule? If a taxpayer files his annual return online and uses a credit card to pay taxes to the IRS, there is a "convenience fee" added to the amount of taxes owed. The same type of fee is added for paying real estate and car taxes online to a local or state government agency. Do the operating rules allow for such additional fee to be charged? If so, why is there a difference in the way your rules treat government versus commercial merchants?

I understand that the four primary payment card networks—American Express, Discover, MasterCard, and Visa—all have different policies with regard to surcharges and convenience fees. I have not studied all of the nuances regarding these policies. I do note, however, that a number of States have laws prohibiting merchants from imposing surcharges on payment card transactions.

With regard to the practice of prohibiting traditional retail merchants from levying a surcharge on a consumer's choice of a particular payment form, the practice makes economic sense for the payment network. Individual merchants act as distributors of the payment systems that they accept. In that role, merchants have an incentive to use the availability of, for example, American Express, to attract customers into their store and then use surcharges to encourage customers to use other forms of payment. Payment networks have good reason to attempt to prevent merchants from doing just that.

4. How much does each interchange transaction actually cost Visa and MasterCard to process? Does Visa and MasterCard make this information publicly available?

I do not know how much it costs Visa or MasterCard to process a particular transaction, and I do not know whether the organizations make this information available. As I explained in my testimony, however, these two companies do not earn revenue directly from interchange. Acquiring banks pay interchange fees to issuing banks on transactions exchanged on a four-party payment system. Visa and MasterCard earn their revenue from processing fees and licensing fees that they charge to the banks that participate in their systems. MasterCard is now a public company, and its financial statements are available through its website. Visa, although not a public company, also posts its annual report, including audited financial statements, on its website.

5. Do you think a cartel can escape antitrust liability by agreeing to appoint a third party to set actual price levels for the cartel?

Legitimate joint ventures are not cartels. As the Supreme Court held in *Texaco Inc. v. Dagher* earlier this year, legitimate joint ventures have the same freedom as other companies to set the price of the products that they sell. *Texaco Inc. v. Dagher*, 126 S.Ct. 1276, 1280 (2006) (finding that "it would be inconsistent with this Court's antitrust

precedents to condemn the internal pricing decisions of a legitimate joint venture as *per se* unlawful"). And there can be no dispute that Visa and MasterCard have been legitimate joint ventures since they were first organized more than three decades ago. The Second, Tenth, and Eleventh Circuits (as well as numerous lower courts) have all recognized the benefits that these two organizations have provided. *United States v. Visa U.S.A., Inc.*, 344 F.3d 229 (2d Cir. 2003); *SCFC ILC, Inc. v. Visa USA, Inc.*, 36 F.3d 958 (10th Cir. 1994); *National Bancard Corp. (NaBanco) v. Visa U.S.A., Inc.*, 779 F.2d 592 (11th Cir. 1986).

With regard to whether Visa and MasterCard can reasonably expect the changes that they made to affect the antitrust analysis of their respective interchange mechanisms, I believe that the answer is yes. As I have made clear, I believe that the historic approaches of both companies are entirely legitimate and do not raise serious antitrust issues. Nevertheless, some merchants have objected to how Visa and MasterCard have set interchange rates on the ground that the two companies have brought otherwise competing financial institutions together to set those rates. Taking financial institutions out of the process of setting the rates should address this objection.

SENATOR DEWINE

1. We have heard from merchants, including some of the witnesses for this hearing, that Visa's and MasterCard's interchange fees are above competitive levels. But, at the same time, we have heard that the number of stores that are choosing to accept Visa or MasterCard is increasing. How do you reconcile these facts?

The payment card systems offer enormous value to merchants, and new merchants embrace electronic payments every day. In fact, payment cards are one of the great innovations of the 20th century, ranking with the cell phone, the microchip, and the personal computer. The business is very competitive at all levels, and issuers, merchant banks, and payment systems are constantly vying for business.

When merchants complain about interchange fees, they are really complaining about what they pay for payments. Merchants do not pay "interchange fees." Interchange is the fee paid by an acquiring bank to an issuing bank on a particular transaction. As they do when they accept American Express and Discover, merchants that accept Visa and MasterCard pay a discount fee on those transactions.

2. After the DOJ's investigation and subsequent challenge of MasterCard's and Visa's exclusivity rules and overlap in corporate governance, interchange fees went up rather than down. Why did this happen? Do you think that Visa's and MasterCard's interchange fees are at or below competitive levels, and why?

Interchange fees balance the two-sided market for issuers and cardholders, on the one hand, and acquirers and merchants, on the other. These fees may go up or down in response to competition for the two sides of the market. As it turns out, the current weighted average interchange rate on the Visa system is actually lower than the rate that prevailed when Visa set the first interchange rate in the early 1970s. Merchants today pay far less to accept payment card transactions than they did when payment cards were first introduced.

In the decision striking down the so-called "exclusivity rules," the court provided American Express the opportunity to target the most desirable issuers. Although American Express has a smaller acceptance network, it can compete for issuers by offering higher rates of compensation for certain transactions. To compete for those transactions, Visa and MasterCard offered issuers higher rates on those types of transactions as well.

Joshua L. Peirez
Senior Vice President &
Associate General Counsel

MasterCard International
Law Department
2000 Purchase Street
Purchase, NY 10577-2509
914 249-5903
Fax 914 249-3648
E-mail joshua_peirez@mastercard.com
www.mastercard.com

MasterCard International

August 28, 2006

The Honorable Arlen Specter
Chairman, Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Specter:

Per your request, attached please find responses to the questions submitted to me by several members of the Committee in connection with the hearing on July 19, 2006, "Credit Card Interchange Rates: Antitrust Concerns?". Please do not hesitate to contact me if I can be of further assistance.

Sincerely,

Joshua L. Peirez

Written Questions from Senator Specter
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. If credit cards are so valuable to merchants, why do the card associations enact rules that prevent merchants from reflecting differences in interchange fees in the prices they charge to their customers? If cards provided valuable benefits to merchants, merchants would *want* customers to use them, and the card associations wouldn't need rules to prevent merchants from discouraging card use through the pricing of their goods and services, correct?

A. MasterCard rules specifically allow for merchants to provide for a cash discount. Section 9.12.2 of our Bylaws and Rules states simply: "A merchant may provide a discount to its customers for cash payment." For example, under our rules a merchant could simply provide a 1% discount to consumers who pay for goods or services with cash. In addition, MasterCard has permitted merchants to surcharge in some markets outside the United States, and we are continuing to review that option for the U.S. market. It is our understanding and experience, however, that as a practical matter merchants have generally decided that they do not want to discount or surcharge based on payment method. Indeed, one of the merchant witnesses at the hearing testified to this fact. As indicated below, Section 9.12.2 is included in the operating rules which we provided as a follow-up to the hearing. We have enclosed an additional copy for your convenience. These rules are also publicly available on our web site, www.mastercard.com, by clicking on the link to "merchant rules".

Historically, federal and state laws have reflected the notion that imposing a surcharge on those who pay by credit card is anti-consumer. For example, for many years the federal Truth in Lending Act contained a prohibition against such surcharges. Although the prohibition expired in 1984, several states continue to prohibit such surcharges.

Q. Mr. Floum has agreed to provide the Committee with a copy of Visa's operating rules. Please do the same for MasterCard.

A. We have attached a copy of all the operating rules currently relating to merchants. As we have discussed with your staff, we will follow up to determine whether there are any other rules you may wish to review.

Written Questions from Senator DeWine
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. We heard testimony that interchange fees continue to go up, yet credit card costs, including card processing, borrowing fraud, and other costs, are reported to have declined. If the credit card industry really is competitive, with decreasing costs and more claimed efficiencies in the credit card payment system, why don't we see interchange fees coming down? Have any interchange fees decreased?

A. MasterCard periodically reviews and adjusts default interchange rates, generally on a semi-annual basis and this process has resulted in downward adjustments to categories of interchange fees. As you have noted, it is reported that some payment card costs have declined and that processing has become more efficient. Such cost decreases have helped contain interchange fees, and processing efficiencies combined with stiff competition have exerted downward pressure on discount fees charged to merchants by acquiring banks. These types of costs and efficiencies, however, are only some of the factors taken into account in setting interchange fees. For example, in recent years, expenditures to prevent fraud, make better credit decisions, and develop new technologies have increased. In addition, MasterCard management must consider other factors such as levels of card issuance and acceptance and our competitors' performance in the marketplace, including the level of prices they are charging.

In short, setting interchange fees is a challenging proposition that involves an extremely delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. In response to competitive forces, MasterCard management works extremely hard to maximize the value of the MasterCard system, including dollar volume spent on MasterCard cards, the number and type of MasterCard cards in circulation, and the number and type of merchants accepting MasterCard cards, by setting default interchange fees at levels that balance the benefits and costs to both cardholders and merchants. Three-party systems like American Express and Discover set their merchant discounts to establish a similar balance, demonstrating that balancing competing interests is not unique to systems that use interchange.

Q. Issuing banks choose which card to issue in part based on which card will give them more revenues from interchange fees. In other words, credit cards compete over issuing banks by offering <u>higher</u> interchange fees. Because of this, competition seems to push prices up rather than down. On the other hand, to attract cardholders, a credit card company needs to be widely accepted, so it needs to attract merchants to accept the cards. This encourages the card companies to <u>lower</u> interchange fees. How do you balance

these two pressures, and how does competition between Visa, MasterCard, American Express, and other cards provide a check on fees?

A. As noted above, setting interchange rates involves a delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. Competition among payment brands and payment types provides a significant check on interchange fees. As I mentioned in my written testimony, MasterCard competes against all forms of payment, including paper-based transactions (such as cash and checks), electronic transactions such as wire transfers and ACH payments, and other electronic forms of payment, including card-based payment systems. Within the general purpose payment card industry, we compete vigorously worldwide with brands such as Visa, American Express and JCB, among others. In the United States, we also compete with other brands such as Discover/Novus. Within the debit segment, we compete with ATM and point-of-sale debit networks in various countries, such as Plus, Electron, Interlink, PULSE, Star, NYCE and Debitman in the United States, Interac in Canada, and EFTPOS in Australia. In addition, we compete against businesses that issue their own private-label payment cards such as retail stores and large petroleum companies.

In addition to our more traditional competitors, we also have competitors that have developed rapidly growing alternative payment systems, such as PayPal, and payments effected via mobile devices, such as cellular phones, transponders and other handheld electronic devices. Among other things, these competitors provide Internet currencies that can be used to buy and sell goods online, "virtual checking" programs that permit the direct debit of consumer checking accounts for online payments, and services that support payments to and from proprietary accounts for Internet, mobile commerce and other applications.

This extensive competition puts downward pressure on interchange rates. If MasterCard were to set default interchange fees that were too high, merchant acceptance of MasterCard-branded cards would suffer as merchants would shift to other payment methods, including those offered by our competitors.

Q. Merchants have claimed that when Visa and MasterCard coordinate on setting interchange fees, or set fees collectively, this violates the antitrust laws. In fact, some merchants have brought antitrust suits challenging the way Visa and MasterCard have set their fees. On the other hand, Mr. Muris has testified that their coordination has been reasonable and pro-competitive. Nonetheless, Visa and MasterCard have made changes in the way interchange fees are set. What changes have you made, and do Visa and MasterCard currently coordinate in any way on setting of any fees?

A. MasterCard does not coordinate with Visa or any other competitor with respect to the setting of interchange or any other fees.

As you note, many of the legal challenges MasterCard has faced with respect to setting interchange rates have been directed at the traditional ownership and governance structure of the four-party system, in which the plaintiffs claim that the customer financial institutions that receive interchange improperly owned the system and controlled the board of directors that set interchange. Although this structure was upheld in the Nabanco case discussed in my written testimony, and we believe the merchants' allegations are without merit, MasterCard has changed its structure and is now a publicly traded company with a majority of directors entirely independent of MasterCard's customers (financial institutions), and with the majority of voting power and equity in the hands of shareholders other than the financial institutions that receive interchange. Moreover, interchange fees are set by MasterCard management, not the MasterCard board.

Written Questions from Senator Grassley
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. How much revenue, per year, is raised because of interchange fees? How much is spent, per year, on making the payment system more efficient and secure?

A. MasterCard itself does not generate revenue from interchange and we generally do not keep statistics on interchange revenues. However, we will follow up with your staff to see how we can be of assistance in obtaining this information.

As for the amount of money spent on making the payment system more efficient and secure, it is difficult to estimate such an expenditure with any precision. However, based on the fact that MasterCard and its nearly 25,000 customer financial institutions devote considerable resources to fraud prevention and system security we estimate that the payment card industry spends tens of billions of dollars—if not more—a year to maintain an efficient and secure payment option for merchants and consumers.

Q. Who sits on the board that sets the policy and rates for interchange fees?

A. Interchange rates are established by management at MasterCard, not the MasterCard board.

Our current board of directors can be found on the Internet at: http://investorrelations.mastercardintl.com/phoenix.zhtml?c=148835&p=irol-govboard.

Q. Who makes the decision to increase interchange fees? Have these fees ever been lowered rather than increased?

A. Interchange rates are established by management at MasterCard. As mentioned in my written testimony, setting interchange fees is a challenging proposition that involves an extremely delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. In response to competitive forces, MasterCard management works extremely hard to maximize the value of the MasterCard system, including dollar volume spent on MasterCard cards, the number and type of MasterCard cards in circulation, and the number and type of merchants accepting MasterCard cards, by setting default interchange fees at levels that balance the benefits and costs to both cardholders and merchants. Three-party systems like American Express and Discover set their merchant discounts to establish a similar balance. Interchange rates are generally reviewed and

adjusted on a semi-annual basis. This process has resulted in both upward and downward adjustments to categories of interchange fees.

Q. Why do merchants have to sign non-disclosure agreements regarding the interchange fee rules? Why is there not more transparency with respect to interchange operations?

A. MasterCard does not require merchants to sign such non-disclosure agreements in this context.

We believe that there is transparency with respect to interchange. Indeed, our interchange rates are generally available to those who wish to see them. For example, a merchant can obtain the rates from its acquiring bank. Furthermore, the rates can typically be found on the Internet. The evidence in the public record also makes it clear that merchants are well aware of what they pay for card acceptance (*i.e.*, their "merchant discount fees"). It is also clear that merchants know more about their merchant discount costs than many other types of costs. For example, the merchant discount shows up as a concise line item to the merchant. However, the costs associated with accepting cash (*e.g.*, stolen or lost cash, store management time spent counting cash drawers, time spent transporting cash, amount spent to protect cash) are not as easily quantifiable for many merchants. Apparently the hidden costs of checks are even greater, including amounts lost due to bad checks, as many merchants will not accept them at all.

It is important to note, however, that MasterCard is a business competing against other businesses and we must protect our internal decision-making processes from disclosure to our competitors. As a result, the fees we establish are available to our customers but the details of our confidential decision-making process are not. Not only is this confidentiality not unusual, it is the essence of competition that a business not disclose to its competitors its specific methodology for setting prices.

Written Questions from Senator Durbin
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. On April 1, 2005, MasterCard introduced a higher fee structure for its premium World card. On the same day, Visa introduced a higher fee structure for your premium Visa Signature card. Was this a mere coincidence that your two competing companies introduced higher fees for the two competing products on the same day, or did MasterCard and Visa communicate with each other to plan the timing of the announcement?

A. MasterCard did not and does not communicate with Visa regarding the setting of fees or the timing of the announcement. MasterCard generally adjusts its interchange schedules on a semi-annual basis.

Q. Why should merchants pay higher fees for premium cards that MasterCard offers to affluent cardholders? What benefits do, say, a convenience store receive for accepting a "World" premiere card that justifies its higher cost compared to other MasterCard cards?

A. In reality, most merchants do not pay a higher merchant discount based on the type of card used by a consumer. Most merchants choose to use a uniform merchant discount rate, called a "blended" rate, regardless of the type of card presented. A smaller number of merchants may decide they would like to pay a higher or lower merchant discount depending on the card presented. However, these decisions are solely the merchants' and are agreed upon as part of contract negotiations with their respective acquiring banks.

It is also important to note that the efficiencies and cost reductions that can be derived from electronic payments (especially for many convenience stores) are greater than those that can be achieved through acceptance of paper-based payments. For example, there are costs associated with cash, such as the costs of protecting it, the costs of counting it, the costs of transporting it, and the costs of losing it or having it stolen. Checks are also not without costs, such as those that are not honored and the increased time per payment transaction.

The acceptance of cards, including premium cards, enables merchants to attract and retain the business of consumers who prefer to use those cards. Certain types of cards, such as premium cards, also benefit many merchants because of the propensity of premium cardholders to purchase more per transaction than other types of cardholders.

Having said that, one cannot simply look at the merchant discount associated with a card to determine whether one is more valuable to merchants than another. The least expensive card is not necessarily going to provide merchants with the most overall benefits. The reasons a merchant accepts payment cards will vary and price is only one

factor in that decision-making process. For example, it is generally understood that today, on average, merchants pay the highest merchant discount for accepting American Express cards, the lowest for accepting Discover cards, and somewhere in between for accepting MasterCard cards. Interestingly, even though Discover is the cheapest to merchants, it is not the most widely accepted or used.

We also note that merchants can use other methods to encourage their customers to use the payment methods the merchant prefers. For example, some merchants actively encourage their customers to use certain types of debit cards that entail lower merchant discounts. Merchants can also refuse to accept brands or types of cards they believe do not provide sufficient value.

SUBMISSIONS FOR THE RECORD

Americans for Consumer Education & Competition

Statement of Rebecca Reid
Executive Director

Americans for Consumer Education and Competition

Senate Judiciary Committee

July 19, 2006

Credit Card Interchange Rates: Anti Trust Issues?

Chairman Specter, Ranking Member Leahy, members of the Committee, my name is Rebecca Reid and I am Executive Director of Americans for Consumer Education and Competition (ACEC), an organization that promotes financial literacy for our youth and advocates for consumers rights. We communicate with more than 25,000 consumers on issues such as theft ID, money management and credit card rewards. Thank you for the opportunity to submit this statement.

As the Senate Judiciary Committee explores the issue of the interchange fee, we ask that you keep at the forefront of your considerations, the impact of regulation on the consumer.

The committee is already aware of the fallout of interchange fee regulation in Australia and how, as the Wall Street Journal recently phrased it, "consumers were the losers, which is what inevitably occurs when governments intervene in markets that aren't broken." The reasons most often cited for consumers getting the short stick upon regulation of the interchange fee have to do with merchant behavior. A 2005 independent analysis of the Australia outcome concluded: *"Taken collectively the direct impacts of the interchange reforms on consumers have been wholly negative. They are paying more in annual fees for credit cards and loyalty schemes, some retailers are now surcharging for credit card usage and they are not seeing lower prices at the checkout."*

Surcharging, often unnoticed by consumers, is a method practiced by some merchants to recoup fees they pay for the ability to provide electronic payment options to consumers. The irony is that many merchants who offer electronic transactions frequently draw a higher volume of customers into their stores and benefit from increased amounts on sales. Yet they want to pass that cost onto the very consumer they market their goods and services to through a check out fee or surcharge. Australia merchants said that if the interchange fee there was regulated, they would lower their prices and not surcharge. We are hearing the same from many merchants in the U.S. and it's critical that we do not repeat recent history in Australia.

Some states have "No Surcharge" laws on the books, while others do not. Only Minnesota allows surcharging up to five percent of the purchase price. Most credit card companies ban merchants from adding an extra fee onto the price of purchase for those consumers choosing to pay with a credit card, however, ensuring that merchants don't penalize consumers proves difficult. On top of that, a study conducted by the Association of Motor Vehicle Administrators shows check processing costs more than the processing of electronic transactions. Card users should not be singled out from those who pay with cash or write a check.

An overwhelming majority of consumers, 89 percent, believe imposing check out fees on those who pay with plastic is an unfair practice and would not purchase goods from merchants who penalize debit and credit card users, according to a 2006 national survey by Americans for Consumer Education and Competition. Our poll, a national survey of 1,000 American adults, indicated that 62% of American adults would abandon their purchase if charged a check out fee for using a debit or credit card. Eighty-two percent of those who reported being surcharged were charged check out fees in the past year. And, 62% percent of those who have been surcharged said getting hit with the fee gave them a negative impression of the retailer.

There should be no question as to the intention of some big merchants when it comes to imposing check out fees on consumers. Mallory Duncan, a senior vice president and the general counsel at the National Retail Federation, was quoted in an article on the interchange fee in American Banker last year saying, "merchants have always wanted the right to surcharge."

Myriad surveys indicate consumers prefer to use their debit card these days over cash for purposes of convenience and security. Consumer behavior shows an unstoppable trend toward the preference of electronic payment. We are buying items through the Internet, paying bills, banking online and buying goods at our local stores with the swipe of a card. Consumers who pay with plastic shouldn't be discriminated against for preferring an easy and safe choice of payment.

As the committee hears testimony today from panelists, please hear the voice of the consumer - here in the United States and across the world in Australia. Merchants should not be allowed to surcharge.

STATEMENT OF W. STEPHEN CANNON *
ON BEHALF OF
THE MERCHANTS PAYMENTS COALITION, INC.

BEFORE THE
UNITED STATES SENATE COMMITTEE ON THE JUDICIARY

HEARING ON
CREDIT CARD INTERCHANGE RATES: ANTITRUST ISSUES?
JULY 19, 2006

I. INTRODUCTION

Chairman Specter and Members of the Committee, I am honored to appear before you today on behalf of the Merchants Payments Coalition (the MPC). The MPC is a group of 19 trade associations[1] representing retailers, restaurants, supermarkets, drug stores, convenience stores, gasoline stations, theater owners, on-line merchants and other businesses that accept debit and credit cards. MPC is fighting for a more competitive and transparent card system that works better for consumers and merchants alike. The coalition's member associations collectively represent about 2.7 million locations and 50 million employees. These merchant associations account for more than 60 percent of the non-automotive card based transaction volume in the United States

The MPC welcomes the Committee's attention to one of the most significant issues ever to face the merchant community. To answer the question posed by the title of today's hearing, there are indeed crucial antitrust issues raised by interchange fees and we would respectfully suggest this Committee is an appropriate place for them to be addressed.

By way of background, I was privileged to serve as Chief Antitrust Counsel to this Committee during the 97th and 98th Congresses (1981-1984). In addition, I have also been fortunate to serve as both a trial attorney and later, as Deputy Assistant Attorney General for Policy and Legislation in the Antitrust Division of the Department of Justice. Further, as General Counsel of Circuit City Stores, Inc. from 1994 to 2005, I had numerous opportunities to see the impact of interchange issues, and I can understand the plight in which merchants and consumers throughout this country find themselves today.

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* Partner, Constantine Cannon, Washington, DC.

[1] MPC's members include the Food Marketing Institute, National Association of Convenience Stores, National Grocers Association, National Retail Federation, National Association of Chain Drug Stores, American Petroleum Institute, Retail Industry Leaders Association, Petroleum Marketers Association of America, Society of Independent Gasoline Marketers of America, National Council of Chain Restaurants, National Association of College Stores, National Association of Truck Stop Operators, International Association of Airport Duty Free Stores, National Association of Theatre Owners, American Beverage Licensees, Bowling Proprietors Association of America, National Association of Shell Marketers, Interactive Travel Services Association, and the National Restaurant Association.

Mr. Chairman, the collective setting of interchange fees represent on-going antitrust violations by the two leading payment card associations—Visa and MasterCard—antitrust violations that costs merchants and their customers—that is, America's consumers—tens of billions of dollars annually. These fees, hidden from consumers, are in addition to the late fees, over-limit fees, and other card fees with which consumers are only too familiar. The purpose of my testimony today is to analyze the competition issues surrounding interchange fees and suggest a range of remedies that the Committee could consider as appropriate solutions to this problem.

My testimony today focuses on three basic topics: The first is the nature of interchange fees and the harm they cause to American merchants and consumers. The second is to explain why interchange fees violate the antitrust laws and why the card associations' justifications are insufficient to overcome this illegality. Last, I focus on the variety of solutions that can address interchange fees in a manner that is in consumers' interest—solutions based on principles of free markets and open competition.

II. WHAT ARE INTERCHANGE FEES AND HOW DO THEY HARM CONSUMERS?

A. Interchange fees represent a nearly $30 billion "sales tax" on merchants—and their customers—collectively set by Visa and MasterCard members.

Mr. Chairman, for far too long American consumers have had to bear the burden of unnecessary and excessive fees charged to merchants by the bank-owned card systems, MasterCard and Visa, organizations that have been held by the courts to have market power in the payment systems marketplace. These fees, called interchange fees, have been set by the collective action of MasterCard and Visa member banks (which include most banks in the United States) and imposed on merchants by the banks to which merchants submit credit card transactions for payment. Merchants must then treat the interchange fee expense as a higher cost-of-doing-business.

When a consumer buys an item with a Visa or MasterCard credit or debit card, the merchant does not receive full face value from the bank to which it submits the charge. The difference between the face value of the customer's purchase and the amount the merchant actually receives is called the "merchant discount," the vast majority of which is the interchange that is paid by the merchant to the bank that issued the customer's card. The average consumer has no idea that this fee is imposed every time they make purchases with their Visa or MasterCard cards. In this way, interchange acts as a hidden sales tax on U.S. commerce, raising both merchant costs and ultimately the price of goods and services sold to consumers.

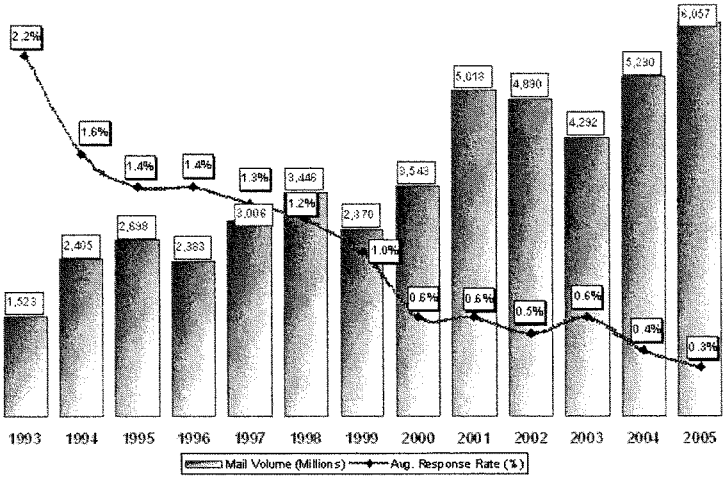
The perverse effects of the current interchange fee system are of growing concern because electronic payments, especially card payments, are an increasing percentage of consumer transactions, replacing checks and cash. For example, the

Federal Reserve reports that, by 2003, the number of electronic payments exceeded the number of check payments for the first time in U. S. history.[2] This event is significant, because checks are cleared at "par" (paid by banks at their face value) and the cost of the checking system is borne by the banking system, with Federal Reserve pricing rules limiting check clearing costs to the cost of processing checks. On the other hand, because card-based payments are credited to a merchant's account only at a discount, merchants not only must pay for costs of the card transaction processing system—but also make a significant contribution to the cost of marketing and issuing cards, themselves.

The key to understanding the anti-consumer nature of the card systems' rules is the fact that the higher Visa and MasterCard set the interchange fees, the more money that will flow to their member banks. This pool of funds is available to subsidize marketing efforts, such as reward points or airline miles, by which card issuers promote customers' use of their credit cards. The fees also support the mass mailings of card solicitations—over 6 billion in 2005—with a mere 0.3 percent response rate, as set out in the following chart.

Figure 1

Credit Card Mail Solicitations and Response Rate



Source: Synovate, April 27, 2006.

[2]"Federal Reserve Studies Confirm Electronic Payments Exceeded Check Payments for the First Time," (Press Release, December 6, 2004); E. Klee, *Families' Use of Payment Mechanisms During a Decade of Change in the U.S. Payments System,* at 1 (Federal Reserve, February 2006).

This system is anticompetitive in several ways. First, these fees have been fixed by banks that compete to issue payment cards to consumers or to sign up merchants to accept Visa and MasterCard cards. No matter which Visa or MasterCard member bank issued the card that is used to make a purchase or which Visa or MasterCard member bank signed up the merchant making the sale, the same uniform fixed interchange rates apply. This system also cements Visa's and MasterCard's substantial individual and joint market power. The higher the interchange fees charged by Visa or MasterCard, the more attractive that card system becomes to banks compared to other card systems.[3] Thus, the member banks have every incentive collectively to ensure that the card system sets high interchange fees.

Because these collectively-set interchange fees are passed on to merchants by banks that process the merchants' card transactions, the merchants inevitably must take this cost into account when pricing the goods or services they sell. As a result, even consumers who pay by cash or check subsidize card-issuing banks' marketing efforts.

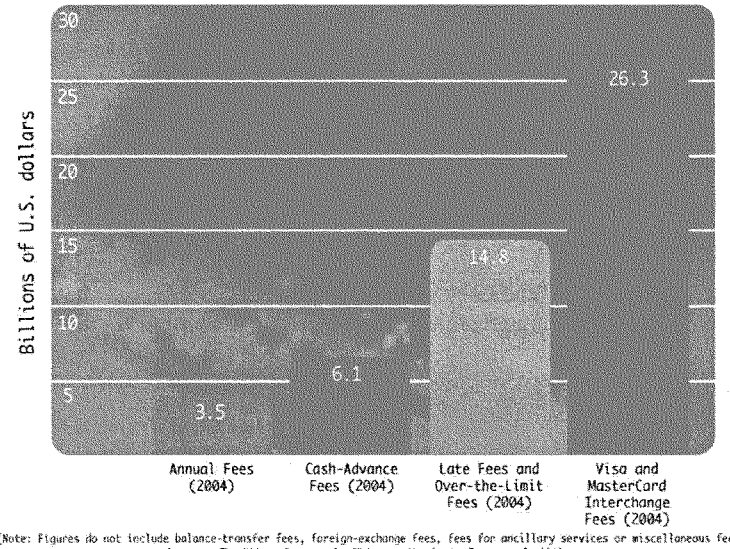
This "sales tax" on ordinary consumers to support users of cards with points, miles, cash-back features, and "concierge" services is a substantial burden on the cost of goods and services that Americans buy. Indeed, merchants are forced to pay higher interchange fees for premium rewards cards, marketed to affluent consumers, such as Visa's Signature Card and MasterCard's World Card to subsidize the higher level of benefits associated with those cards. These activities are, of course, the way in which a card association's card issuers compete *among themselves* for cardholders. The resulting burden on U.S. merchants and their customers is substantial: Visa and MasterCard interchange fees totaled $26.3 billion in 2004, and are expected to increase significantly.[4] These fees dwarf the more visible card fees, as set out in Figure 2.

[3] Until October 2004, when the Final Judgment in *U.S. v. Visa/MasterCard* went into effect, Visa and MasterCard member banks were effectively precluded from participating in other systems, such as Discover and American Express, by exclusionary rules passed by Visa and MasterCard. These rules – Visa bylaw 2.10(e) and MasterCard's Competitive Programs Policy – were rescinded in accordance with the Final Judgment in *U.S. v. Visa/MasterCard*.

[4] See Food Marketing Institute, "Hidden Credit Card Fees" (2005).

Figure 2

Total Card Fees By Type (2004)

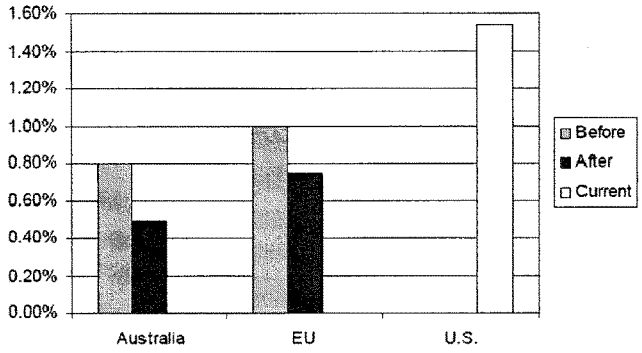


(Note: Figures do not include balance-transfer fees, foreign-exchange fees, fees for ancillary services or miscellaneous fees)
Sources: The Nilson Report, CardWeb.com, Merchants Payments Coalition

Tellingly, in other nations that have put an end to this price-fixing scheme by Visa and MasterCard, merchants pay lower interchange fees. Moreover, given the size of the U.S. economy, one would expect the MasterCard and Visa systems in the U.S. to have scale and scope economies that would permit the card associations to serve American merchants and consumers at a lower price than in other countries. This is not the case. As demonstrated by the following chart, U.S. merchants and consumers are subject to significantly higher interchange fees than in other countries.[5]

[5] From F. Hayashi, Federal Reserve Bank of Kansas City, "A Puzzle of Card Payment Pricing: Why are Merchants Still Accepting Card Payments?" *Review of Network Economics,* at 145 (March 2006) ("In the United States, interchange fees for both credit and debit card transactions are among the highest in the world. Moreover, they have been increasing rapidly for the past several years.").

Figure 3
Credit card interchange rates in selected countries



Notes: "Before"= before the rate was forced to be lowered, "After"=after the rate was lowered; "Current" = as of November, 2004. The rates in Australia and the United States are the average of Visa and MasterCard rates. In the EU, the European Commission made its decision on the Visa rate for cross-border transactions only. The 'before' rate is not publicly available, but the rate was estimated at about 1 percent.
Sources: Reserve Bank of Australia, Visa Europe, MasterCard International, and American Banker.

B. The costs of card-associations' price-fixing efforts are hidden from consumers.

The card associations make every effort to ensure that card holders remain unaware of the interchange fee costs their usage of cards imposes. First, card association rules require merchants to advertise the price that a card user would pay as the primary advertised price. Second, card association rules prevent merchants from using different prices to reflect the different levels of interchange fees associated with different types or brands of payment cards.[6]

As noted, the heart of the problem is that many card holders want to use cards because they are *paid* to use them through reward points and other enticements subsidized by the interchange fee, even though their card use imposes a burden on merchants and all of their customers. A recent study by the Kansas City Federal Reserve Bank concludes that merchants realistically cannot refuse to accept Visa and MasterCard payment cards, regardless of interchange fee costs.[7]

[6] Interchange fees vary by brand association, type of card (debit or credit), and benefit level. In particular, Visa's "Signature" brand and MasterCard's "World" brand, as well as "business" cards, usually incur a higher interchange fee than standard Visa or MasterCard transactions. The card associations' rules nominally permitting "cash" discounts actually prohibit the use of discounts that reflect differences in fees for debit cards compared to credit cards, or among the various brands and types of each card.
[7] F. Hayashi, "A Puzzle of Card Payment Pricing: Why are Merchants Still Accepting Card Payments?" *Review of Network Economics*, at 172 (March 2006) (footnote omitted).

Indeed, the Federal Reserve Board informed Congress in a 2004 report on disclosure of fees for the use of debit cards, "Because these interchange fees are generally unknown to consumers, most people still remain unaware of the effects of their choices on merchants' costs or card issuers' revenues."[8] The result of Visa and MasterCard interchange fees thus is to distort choices consumers make regarding their payment methods because of the lack of a linkage between the costs card usage imposes on merchants (and the consumer) and the price signals perceived by the card user. Consequently, card holders may choose a payment method that is the most expensive to merchants and consumers, while they may perceive its use as "free," or even having a positive value through the collection of points or miles.

In sum, the combination of interchange fees and card system rules limiting retail pricing flexibility distorts the price signals regarding the use of cards and thus the nature of competition between payment systems. The higher cost to merchants for customer use of payment cards flows through into higher prices for the customers of those merchants. Interchange fees thus become a cost borne by *all* consumers whether they use cards or not.

III. THE SETTING OF INTERCHANGE FEES BY CARD ASSOCIATION MEMBERS (OR THEIR AGENTS) IS UNLAWFUL.

A. The setting of interchange fees constitutes horizontal price fixing.

In the landmark Department of Justice case against Visa and MasterCard, the Court of Appeals for the Second Circuit found that when Visa and MasterCard pass rules, their actions are the actions of "consortiums of competitors" (banks) that compete to issue cards or to sign up merchants to accept Visa or MasterCard cards.[9] That rationale would equally apply to the associations' fixing of interchange by Visa and MasterCard. As discussed above, interchange fees are fees imposed on merchants (and consumers) by Visa and MasterCard members (who are competitors).[10] The collective setting of interchange fees (by or on behalf of their member banks) by the card associations effectively cartelizes the setting of interchange fees by removing any incentive for card issuing banks

[8] Board of Governors of the Federal Reserve System, *Report to the Congress on the Disclosure of Point-of-Sale Debit Fees,* at 14 (November 2004).

[9] *United States v. Visa U.S.A., Inc.*, 344 F. 3d 229, 242 (2d Cir. 2003)

[10] Interchange fee proponents may argue that the interchange fee is not a "price" charge by issuing banks to acquiring banks but a "transfer payment" between the two sides of the transaction, since interchange fees do not compensate issuing banks for any specific services provided. As interchange fees are virtually always treated as a pass through charged to merchants by acquiring banks, interchange fees are, in truth, a price fixed by a cartel of competing issuers that is paid by merchants on every Visa and MasterCard transaction in the United States.

individually to lower interchange fees in response to requests from merchants and acquiring banks.[11]

Moreover, in conjunction with the associations' related rules restricting merchants' pricing flexibility and cost disclosure, merchants are unable to charge cardholders a differentiated price based on differences in interchange fees. As a result, the associations have the incentive and ability to exercise this pricing power on behalf of their members to charge a supra-competitive price to the merchant, precisely the "evil" at which the Sherman Act's pricing-fixing prohibition was directed. Indeed, from the earliest days of antitrust, courts have recognized that cartel rate-setting is inherently anticompetitive regardless of the claimed "reasonableness" of the prices a cartel might set.[12]

B. MasterCard's IPO does not end the illegality of its interchange fee mechanism.

MasterCard's recent reorganization is a change in form, not substance: collective price-fixing continues. The antitrust laws recognize a hub-and-spoke form of conspiracy in which a central agent manages a cartel even if the conspirators do not expressly agree with each other to go along with the "hub's" plan.[13] The case is strongest where there is an agreement among members along the "rim" to utilize the hub.[14] This is precisely the case with the MasterCard reorganization.

Under the reorganization, MasterCard International undertook an initial public offering that sold a significant share of equity and voting rights to the public.[15] Nevertheless, as MasterCard's filings with the Securities and Exchange Commission make clear, post-reorganization, the fundamental structure of the MasterCard system would remain, particularly the interchange fee system, which was explained in some detail.[16] That the overall business approach of MasterCard would remain intact is unsurprising, because, as MasterCard readily admits, a key motivator for the reorganization was that: "[W]e have faced heightened regulatory scrutiny and legal challenges in recent years. ... We believe our new structure will place our business in a stronger position as we will be better able to defend ourselves against legal and regulatory challenges involving our ownership and governance."[17] That is, MasterCard implicitly assumed it could escape from

[11] In a decision in the recently-settled *Visa USA v. First Data Corp.* litigation, a district court ruled that Visa was not a "single entity" and its actions could be considered to be the result of collective action by its members. 2006 WL 516662 (N.D. Cal., March 2, 2006).
[12] E.g., *United States v. Trenton Potteries Co.*, 273 U.S. 392, 397 (1927) ("The power to fix prices, whether reasonably exercised or not, involves the power to control the market and to fix arbitrary and unreasonable prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow.")
[13] See, e.g., *Toys "R" Us v. FTC,* 221 F.3d 928, 932 (Seventh Circuit, 2000).
[14] See, e.g., *Spectators' Communication Network v. Colonial Country Club,* 253 F. 3d 215 (Fifth Circuit, 2001).
[15] See, "Is MasterCard Stock Priceless?" *Wall Street Journal Online* (July 12, 2006).
[16] See MasterCard Incorporated, SEC Form S-1, Amendment No. 8, p. 76 (May 23, 2006).
[17] *Ibid.*, at 72-73.

future antitrust liability for its existing business practices because a separate, "independent" board would continue to serve as cartel manager for the members, without the need for members, themselves, to agree on specific interchange fee levels.

Such a legal sleight-of-hand is simply unavailing. First, by agreeing to the reorganization, based on the representation that existing agreements, including the interchange fee mechanism, would continue, the members have agreed to use the services of MasterCard, Inc. as manager of their existing interchange fee cartel arrangement. Second, when the MasterCard members agreed to designate MasterCard, Inc., as the ongoing manager of the MasterCard system, they had every reason to believe that its board would operate in their collective best interest as cartel agent: the member banks would remain significant MasterCard shareholders with a collective 44 percent equity interest (plus a 10 percent equity and 18 percent voting interest in a "MasterCard Foundation," with restrictions on the aggregate accumulation of stock by outside parties), they would appoint members to the board with certain voting rights, and they would remain MasterCard's only customers—and MasterCard is dependent on their customer-members' goodwill toward MasterCard.[18]

As MasterCard put it, "We are, and will continue to be, significantly dependent on our relationships with our issuers and acquirers [member banks]...."[19] Indeed, the five largest MasterCard member banks provided 34 percent of MasterCard Inc.'s revenue as of early 2006.[20] And, of course, a consideration for those large issuers remaining in the MasterCard system could be the level of interchange fees paid to them in comparison with, for example, Visa. Thus, even an "independent" MasterCard board could be expected to assume the best interests of all MasterCard shareholders would result from setting interchange fees at levels that are in the collective best interest of issuing banks, particularly MasterCard's dominant issuers. And, as the saying goes the proof of the pudding is in the eating: Since the IPO, MasterCard's interchange rates and rules have not changed one bit. The price fixing continues unabated.

C. Interchange fees are unlawful, anticompetitive restraints.

1. Visa and MasterCard's price fixing are not "ancillary restraints."

Visa and MasterCard may argue that the so-called "ancillary restraints" doctrine saves them from liability for their price fixing. As explained below, this technical argument does not offer Visa and MasterCard a defense to their illegal conduct.

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[18] *Ibid.*, at 6-7, 30.
[19] *Ibid.*, at 21.
[20] *Ibid.*, at 20.

Under the "ancillary restraints" doctrine established by cases such as *BMI,*[21] an agreement that is adopted by competitors as part of a joint venture arrangement may be evaluated under the Sherman Act's "rule of reason," rather than being condemned as *per se* unlawful. In turn, the agreement can survive a rule of reason analysis "if it is no greater than reasonably necessary to achieve a legitimate commercial objective (i.e., has a procompetitive purpose), has no substantial anticompetitive impact, and is no broader than necessary to accomplish its pro-competitive goals."[22] Clearly that is not the case here.

The card associations may argue that the Supreme Court's recent decision in *Texaco Inc. v. Dagher*, 126 S.Ct. 1276 (2006) should be interpreted to mean that competitors need merely form a simple joint venture to have free rein to engage in otherwise illegal collusive activity such as price fixing, even if such price fixing is unrelated to any pro-competitive justification for the joint venture.[23] Such an interpretation, however, would contravene well-settled law.

For example, as noted in the *NCAA* case[24] cited approvingly in *Dagher*, "joint ventures have no immunity from the antitrust laws...." 468 U.S. at 113. Simply "labeling an arrangement a 'joint venture' will not protect what is merely a device to raise price or restrict output." U.S. Dept. of Justice, *Competitor Collaboration Guidelines* at § 3.2 ("Agreements Challenged as Per Se Illegal"). "The fact that there is common ownership or control of the contracting corporations does not liberate them from the impact of the antitrust laws." *Timken Roller Bearing Co. v. United States*, 341 U.S. 593, 598 (1951) (condemning restraints that went "far beyond" the legitimate, pro-competitive purpose of the joint venture and "provided for control of the manufacture and sale" in a manner that "avoid[ed] all competition either among themselves or with others" *Id.* at 597, 598). The *Timken* Court further held that it did not find any "support in reason or authority for the proposition that agreements between legally separate persons and companies to suppress competition among themselves and others can be justified by labeling the project a 'joint venture.' Perhaps every agreement and combination to restrain trade could be so labeled." *Id.* at 598. The Supreme Court's analysis twenty years later in *Catalano Inc. v. Target Sales, Inc.*, 446 U.S. 643 (1980) – also cited approvingly in *Dagher* – reinforces this point. In condemning an agreement among wholesalers to eliminate short-term credit on beer purchases, the Supreme Court observed that "[i]t has long been settled that an agreement to fix prices is unlawful per se" and "the machinery employed by a combination for price-fixing is immaterial." *Id.* at 647.

Moreover, interchange fees are *not* fees charged by a joint venture for products or services sold by the joint venture. Rather, they are fees that association members

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[21] *Broadcast Music, Inc. v. Columbia Broadcasting Co.*, 441 U.S. 1 (1979).
[22] As summarized in *National Bancard Corp. (NaBANCO) v. Visa USA*, 779 F. 2d 592, 601 (Eleventh Circuit, 1986).
[23] Visa USA was a party to an amicus brief filed in the Supreme Court on this case.
[24] *National Collegiate Athletic Association v. Board of Regents of Univ. of Okla.*, 468 U.S. 85 (1984).

have agreed that *each bank* that issues cards would charge to the banks that process merchant transactions. As MasterCard's recent SEC filings clearly state:

> Generally, interchange fees are collected from acquirers [merchants' banks] and passed to [card] issuers to reimburse the issuers for a portion of the costs incurred by them in providing services which benefit all participants in the system, including acquirers and merchants. ... We administer the collection and remittance of MIFs [multilateral interchange fees] through the settlement process; however, we generally do not earn revenues from them. As noted above, MIFs are a significant component of the costs that merchants pay to accept payment cards and are subject to regulatory or legal challenges in a number of jurisdictions.[25]

Thus, reliance on precedents applicable to the setting of a joint venture's own prices is irrelevant to an ancillary restraints analysis of interchange fees.

Indeed, in recent years, various antitrust authorities of America's trading partners have found interchange fee mechanisms to be unlawful restraints under relevant competition laws of their respective jurisdictions. These findings of illegality include:

- Australia, 2000 (by the Australian Competition and Consumer Commission);
- European Commission, 2002 (cross-border transaction by Visa);
- Spain, April 2005 (interchange fees of major card associations) Competition Court of Spain;
- United Kingdom, September 2005, (MasterCard), Office of Fair Trading;[26] and
- European Commission, June 23, 2006 (Statement of Objections to MasterCard based on the preliminary view that its credit and debit card interchange fee mechanisms are unlawful).

At a July 17, 2006 hearing on the payment card industry, the E.C.'s Competition Commissioner stated that collectively set interchange fees amount "to a 'tax' on businesses and consumers," and that if the card industry did not take corrective measures, the E.C. would undertake antitrust enforcement action.[27]

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[25] MasterCard Incorporated, SEC Form S-1, Amendment No. 8, p. 76.
[26] This decision was recently "set aside" by the UK Competition Appeals Tribunal, after the OFT sought to withdraw the decision based on "procedural" considerations. The OFT stated that it remains of the view that the MasterCard and Visa interchange fee mechanisms could be unlawful. Press Release, June 20, 2006.
[27] "EU Kroes Urges Credit Card Companies to Revise Practices," Dow Jones Newswire (July 17, 2006).

No similar action has been taken by antitrust authorities in the U.S., perhaps based on the existence of the Eleventh Circuit's 1986 decision in the NaBANCO case[28] a decision from credit cards' "infant industry" days. The NaBANCO court found Visa's interchange fee mechanism to be a reasonable ancillary restraint. Regardless of the validity of this holding at the time it was made, such a finding is no longer supportable.

2. The 20-year-old *NaBANCO* decision is based on factual assumptions no longer relevant to the payment card marketplace.

Visa and MasterCard evolved from regional and local credit card systems during the 1960's and 1970's. Originally paper-based, in the 1980's the credit card networks moved to electronic processing of many transactions. During this start-up period, Visa and MasterCard faced the challenges of creating incentives for banks to issue their respective cards, and also for banks to recruit merchants into accepting those cards by accepting card transactions for processing and payment through those card networks. In this context, Visa claimed it adopted interchange fees to allocate costs and revenues among the banks issuing cards, and those dealing with merchants: "[The interchange fee] serves the function of re-distributing the costs of the VISA service more equitably between the merchant and card-issuer sides, *that is, it is a "transfer payment" of sorts.*"[29]

The 1986 NaBANCO decision was based on facts now a quarter of a century old, a time when, "The present VISA business arrangement is relatively young."[30] In NaBANCO , the appeals court upheld a district court's the finding that, applying the rule of reason, the interchange fee was valid "on two separate and independent grounds." First, the district court had determined "that VISA did not possess power in that [all payment devices] market. ... Second the court found that [assuming VISA has market power], on balance, the interchange fee is pro-competitive in nature ... and reasonably cost related," and was necessary to give banks incentives to issue Visa cards. 779 F. 2d, at 603.

The *NaBANCO* findings are, however, directly undercut: (a) by the Second Circuit's 2003 finding (in *United States v. Visa U.S.A., Inc.*) that Visa and MasterCard now have market power; (b) by rulings that other card association rules defended as "reasonable" have been found to be unlawful; and (c) by the findings of competition authorities that the justifications provided by Visa and MasterCard for the interchange fee are not supported by today's market facts.

a. Federal courts have found Visa and MasterCard to have market power today.

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[28] *National Bancard Corp. (NaBANCO) v. Visa USA,* 779 F. 2d 592 (Eleventh Circuit, 1986)..

[29] *National Bancard Corp. (NaBANCO) v. Visa USA,* 596 F. Supp. 1231, 1260-61 (S. D. Fla., 1984, emphasis added).

[30] 596 F. Supp. 1231, 1263 (S. D. Fla., 1984).

The facts relied upon in the *NaBANCO* decision have no relevance to the payment card market place in the 21st century. Most significantly, the payment card industry is not "young," but decidedly mature, with most Americans having a credit card and/or debit card. Indeed, as of 2001, over 72 percent of American households had credit cards.[31]

The Second Circuit held in *United States v. Visa U.S.A., Inc.*, 344 F. 3d 229, 239-40 (2d Cir. 2003) that in today's business environment, Visa and MasterCard have market power in the market for network services for general purpose cards. Following a thirty-four day trial, the *Visa U.S.A.* district court defined this market as the one in which networks such as Visa and MasterCard "provide the infrastructure and mechanisms through which general purpose card transactions are conducted, including the authorization, settlement, and clearance of transactions." *United States v. Visa U.S.A., Inc.*, 163 F.Supp.2d 322, 338 (S.D.N.Y. 2001). The court also noted that "[m]erchant acceptance of a card brand is also defined and controlled at the system level and the merchant discount rate is established, directly or indirectly, by the networks." *Id.* Based upon the facts in the record – that the market is highly concentrated and there are high barriers to entry – the Second Circuit affirmed the trial court, ruling that Visa and MasterCard "jointly and separately, have power within the market for network services" for general purpose cards. 344 F. 3d at 239.

In addition, in an antitrust case brought in 1997 by merchants who claimed that Visa and MasterCard acted in violation of the antitrust laws by making merchants who accepted an association's credit cards also accept its debit cards, the district court held that "Visa possesses appreciable economic power" in the credit card services market. *In re Visa Check/Mastermoney Antitrust Litigation*, 2003 WL 1712568 at *3 (E.D.N.Y. April 1, 2003). The court noted that the "evidence establishes conclusively that merchants have not switched to other payment devices despite significant increases in the interchange fees on the defendants' credit cards." *Id.* ("there is no cross-elasticity of demand at the merchant level between the defendants' products and all other forms of payment"). In fact, the court pointed out, Visa itself had "adopted this market definition, excluding all forms of payment except credit and charge cards" in a previous case. *Id.*[32] Finding that Visa's share of the general purpose credit and charge market had ranged from 41 percent to 47 percent during 1991-98 and that Visa's share of the credit card market alone was nearly 60 percent, the court held that Visa "easily qualifie[d] as [having] 'appreciable economic power' for purposes of the per se rule." *Id.* at *4 (citation omitted).

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[31] U.S. Census Bureau, *Statistical Abstract 2006,* Table 1176.

[32] Citing *SCFC ILC, Inc. v. Visa U.S.A., Inc.*, 36 F.3d 958, 966 (10th Cir. 1994) ("Visa stipulated 'the relevant market is the general purpose card market in the United States'").

b. Key Visa and MasterCard rules recently have been found to have failed "rule of reason" analyses.

Visa and MasterCard are no strangers to adverse outcomes in antitrust litigation challenging their rules under an ancillary restraint form of analysis. For example, in its recent case, the Justice Department successfully challenged Visa's and MasterCard's "so-called 'exclusionary' or 'exclusivity' rules, which prohibited members of their networks from issuing Amex and Discover cards." *Visa U.S.A.*, 344 F. 3d at 237. The Second Circuit affirmed the lower court's holding that Visa and MasterCard engaged in an antitrust violation by using these exclusionary rules to "effectively foreclose[] [Amex and Discover] from the business of issuing cards through banks." *Id.* "Since [Visa's and MasterCard's] exclusionary rules undeniably reduce output and harm consumer welfare, and defendants have offered no persuasive procompetitive justification for them, these rules constitute agreements that unreasonably restrain interstate commerce in violation of Section 1 of the Sherman Act." *Visa U.S.A., Inc.*, 163 F.Supp.2d at 406.

In addition to being found to have violated the antitrust laws in the government case, Visa and MasterCard also agreed to an unprecedented settlement of the antitrust claims brought by merchants in the *In re Visa Check* case. There, a class of approximately 5 million merchants (including Wal-Mart, Sears, Circuit City, the Limited, and Safeway) sued Visa and MasterCard for alleged violations of Sections 1 and 2 of the Sherman Act:

First, plaintiffs claimed that the defendants' 'Honor All Cards' policy, which forced merchants who accepted Visa and MasterCard credit cards to accept Visa and MasterCard debit cards, was an illegal 'tying arrangement' that violated Section 1 of the Sherman Act. Second, plaintiffs alleged that defendants used their Honor All Cards policy in conjunction with other anti-competitive conduct to monopolize the debit card market, in violation of Section 2 of the Sherman Act. *Wal-Mart Stores, Inc., v. Visa U.S.A., Inc.*, 396 F. 3d 96, 100-01 (2d Cir. 2005).

Rather than face trial on these claims, Visa and MasterCard entered into the largest settlement in antitrust history. In fact, the court noted that it was "the largest settlement ever approved by a federal court." *In re Visa Check/Mastermoney Antitrust Litigation*, 297 F. Supp. 2d 503, 511 (E.D.N.Y. 2003) (citation and internal quotation marks omitted). Specifically, the cash portion of the settlement had a present value of $3.383 billion, and the court valued the significant injunctive relief at "$25 to $87 billion or more." *Id.* at 509, 511-12.

Earlier this month, Visa settled a complaint by First Data, a processor of Visa transactions, after the court had denied summary judgment motions. Among other alleged antitrust violations, First Data had claimed it was damaged by Visa's rules requiring an honoring of all credit or debit cards, its limitation on point of sale discounts, and its ban on Visa member banks from processing Visa transactions outside the Visa network. As summarized by the court, damages

arose from the claim that the aggregate effect of the Visa restrictions "works to maintain a supra-competitive interchange structure by preventing issuing banks from competing over merchant business which might have the overall effect of requiring Visa to lower its interchange fees."[33]

c. Empirical Analyses by Competition and Financial Authorities Have Undercut the Card Associations' Justification for Interchange Fees

On April 12, 2006, the European Commission's Directorates for Competition and Financial Services jointly issued a preliminary report analyzing interchange fees based on a comprehensive analysis of the major card systems' operations *in all 25* European Union countries. Among other conclusions, the report found:

- Profitability in card issuing is high and has been sustained over time. The credit card business is particularly profitable.... High profitability is often correlated with high fees charged to merchants and card holders. The evidence also suggests that even in the absence of an interchange fee, other revenues alone would in many cases generate a healthy profit for issuers. (p. iv)

- The empirical evidence shows that if the interchange fee increases by 1 Euro, only 25 cents are passed on to consumers in lower fees. The result challenges the hypothesis advanced by some industry participants and the economic literature that an increase in interchange fees exactly equals a decrease in cardholder fees. Overall, the inquiry has not confirmed the possible justifications for interchange fees which rely on economic efficiency arguments. (p. vi)

- The Commission's sector inquiry provides indications that interchange fees are not intrinsic to the operation of card payment systems, as several national systems operate without an interchange fee mechanism. The use of interchange fees may, however, serve several purposes. From a competition viewpoint, it would appear <u>important to what extent interchange fees are de facto (also) used as a tool to extract rents from merchants.</u> In this context, some of the preliminary findings in this report, in particular those showing strong country divergences in interchange fees and between merchant segments, may provide indications that the setting of interchange fees could possibly be a matter of market power in some EU Member States. (p. 32, emphasis in original)

Indeed, one European Commission finding directly contradicts the "cost-revenue balancing" justification for interchange fees upheld by the courts in *NaBANCO*:

> [T]hese results [of the EC's empirical analyses] also seem to cast substantial doubt on the justifications for the existence of interchange fees

[33] *Visa USA v. First Data Corp.*, 2006 WL 1310448 (N.D. Cal., May 12, 2006).

> put forward by the payment card systems. For instance, one international network believes that in the absence of ... interchange fees paid by acquirers to issuers, issuers would have to recoup all of their costs from cardholders and this would lead to a level of card issuing that is "not optimal" for the system as a whole. This statement seems to be largely refuted by our results. The justification put forward by another international network, which considers that the interchange fee provides for a transfer of revenue between issuers and acquirers to achieve the optimal delivery of services by both acquirers and issuers to merchants and cardholders, is also not supported by our results. ... In such a context, the role of interchange fees as a "mechanism to redress the imbalance between issuers' and acquirers' costs and revenues in delivering a payment card service" is not readily understandable. (p. 71)

Similarly, the Australian experience has refuted claims that decreases in interchange fees would undercut the viability of card systems. In fact, after three year's experience with reduced interchange fees, following intervention by the Reserve Bank of Australia, credit card applications are at record highs, along with the use of credit.[34] The reason seems straight forward: with the reduction in interchange fees, credit card issuers have been forced to rely on price competition (on interest rates) rather than solely on rewards points. In addition, consumers in general benefit when merchants pass through their interchange fee savings in their retail prices.[35]

Whether a consumer uses a low-priced, low rewards card, or a higher priced card, with rewards, is a choice that appropriately should be the consumer's to make. Increasing the range of card offerings serves the goals of competition policy. Giving consumers the choice of which approach to take is precisely the outcome that competitive markets—free of cartel pricing restrictions—should make. As the official of the Australian central bank responsible for overseeing interchange fee regulation recently testified to the Australian Parliament, the reduction of interchange fees has resulted in banks focusing on the interest rate-sensitive segment of the consumer marketplace:

> The credit card business was very profitable and the banks were focusing their competitive efforts on giving reward points to card holders. The idea

[34] See, "Big rush for new credit cards," *The Australian* (January 25, 2006) ("[W]ith the explosion in credit card applications, debt levels also swelled."); "Rates Fall on Credit Cards," *The Australian* (February 14, 2006) ("Australians have never had easier access to a credit card with banks undercutting each other in the battle for the consumer dollar.").

[35] Some critics of Australian regulation claim that lower interchange fees have not been fully passed through to consumers in the near term, in part due to the concentrated nature of Australian retailing, e.g., H. Chang, D. Evans, S. Garcia Swartz, *The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia* (2005) ("Many merchant categories appear to have significant levels of concentration," p. 11). Whatever the validity of the observations concerning the retail pass through of interchange fee reductions in Australia, the highly competitive nature of American retailing would lead to the rapid pass through of lower interchange fees.

> that you would go and compete for credit card customers by lowering an interest rate seemed foreign to many financial institutions. What they wanted to do was attract people by offering a very generous reward scheme. That was where the competition in the credit card industry reflected itself, not on interest rates. But, since we have seen the lower interchange fees come into existence, we have seen the competitive dynamics realign themselves and people are now focusing on that segment of the market, whereas previously that was not the case.[36]

Indeed, MasterCard complained to the Reserve Bank about having its members forced to compete on price:

> MasterCard does not disagree that there is, *at present,* strong competition amongst issuers of credit cards. Such competition has been enhanced by the fact that, at present, issuers have been able to recover eligible costs.... One distinct characteristic of the product offerings in recent times, however, has been the increase in the number of "low cost" credit card offerings. While MasterCard believes that it is beneficial for there to be "low cost" credit card products being offered, it also believes that, with the common benchmark interchange fee, in the future there will be fewer "fully featured" credit card offerings and the competition between issuers will be based on increasingly homogeneous "low cost" credit card offerings.[37]

Thus, the evidence is clearly mounting that the theoretical arguments in favor of any use of interchange fees as a subsidy for card-issuers' costs are factually unsupportable, and cannot serve as a justification for cartel price fixing.

IV. A RANGE OF POSSIBLE REMEDIES EXISTS TO ADDRESS VISA'S AND MASTERCARD'S ILLEGAL PRICE FIXING

A. The antitrust laws provide an appropriate framework for addressing changes from the current interchange fee mechanism.

A determination that the card associations' price fixing is unlawful under the antitrust laws is just the first step: the important public policy issue is the appropriate form of relief against future violations. A range of options is possible in dealing with these antitrust problems, including enhancing competition and increasing transparency in the payment card market.

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[36] Testimony of Dr. Philip Lowe, Assistant Governor, Reserve Bank of Australia, Official Committee Hansard, House of Representatives Standing Committee on Economics, Finance, and Public Administration, at 51 (May 16, 2006).

[37] (Letter from Senior Vice President—Australasia, MasterCard International to Head of Payments Policy, Reserve Bank of Australia, August 25, 2005, page 3 (emphasis in original).)

With the exception of Australia, our key trading partners have addressed the problem of collectively-set interchange fees as an antitrust/competition policy problem, rather than a problem for banking regulators. A November 2005 study by the Federal Reserve Bank of Kansas City found that, as payment systems migrate from paper to electronics, "central banks are paying increasing attention to credit and debit card industries." However, "specific interchange-fee and other payment competition issues fall under the jurisdiction of competition ... authorities. ... [I]t is the competition authorities that have taken the lead in evaluating and ... bringing about change in credit and debit card markets."[38]

Even in Australia, the key impetus for regulation was the failure of card-issuing banks to reach a settlement with the Australian Competition and Consumer Commission following its finding that the collective fixing of interchange fees was unlawful. As a result, in March 2001, the head of that antitrust agency requested that the Reserve Bank of Australia use its statutory powers to address the interchange fee problem through regulation—and the Reserve Bank did so.

In contrast to our trading partners, such as the European Union and the United Kingdom, the United States has, to date, only approached prices and rules imposed by card joint ventures through piecemeal antitrust litigation. On April 24, 2006, numerous merchants filed a consolidated complaint in a consolidated class action litigation[39] challenging collectively set interchange fees. If there is a merits ruling in favor of the plaintiffs, or a settlement, the court in that case would, of course, have to address appropriate prospective remedies.

B. A range of relief alternatives is available.

A broad range of remedy options exist in an antitrust context. We take no position on these options now but air them simply as illustrative examples. Antitrust remedies may include:

1. Simply holding the collective setting of interchange fees to be unlawful price fixing and leave it to the card associations and their members to comply with this prohibitory order.

2. Establishing "safe harbors" in a consent decree (before or after a finding of liability) between the parties that would not be considered to be antitrust violations.

3. Permitting collective negotiation between merchants (or classes) of merchants and a card system's issuing banks, regarding interchange fees, since it is the merchants (and their customers) who pay the cost of

[38] S. Weiner and J. Wright, *Interchange Fees in Various Countries: Developments and Determinants*, 24-25 (2005).
[39] *In Re Payment Card Interchange Fee and Merchant-Discount Antitrust Litigation*, First Consolidated Amended Class Action Complaint, No. 1:05-md-1720-JG-JGO (Eastern District, NY, April 24, 2006).

interchange fees. This Committee has experience in enacting a statutory framework where there is a need to reach agreement but the sides have multiple parties and unequal bargaining power.

4. Leaving it up to a federal judge to design a remedial scheme for the industry.

Other alternatives are possible, of course, and should be explored.

A regulatory solution is also possible. Australia has a well-developed regulatory mechanism, adopted after the card associations there failed to reach an agreement with that country's competition authority under Australian antitrust laws. As discussed above, these rules have both lowered interchange fees to merchants and their customers, and encouraged Australian card issuers to compete on the basis of lower interest rates rather than through greater rewards.

C. The benefits of a congressional solution: lessons from the AT&T divestiture.

During the 1970's and early 1980's, Congress wrestled with the "Bell System problem." That is, AT&T was vertically integrated into (a) regulated monopoly local telephone service and (b) competitive or potentially competitive long distance services and equipment manufacture and sale. It thus had the incentive and ability to monopolize those competitive markets. Many in the industry, as well as at the Justice Department, believed it had unlawfully acted on those incentives. Congress attempted a range of legislative solutions, but by the end of 1981, none had been enacted. Meanwhile, in 1974, the Justice Department had filed suit against the Bell System, alleging multiple violations of Sherman Act section 2's monopolization prohibitions.

As counsel to this Committee beginning in 1981, I had the opportunity to work with the Committee's members in developing amendments to deal with AT&T. While that legislation did pass the Senate, it never made it through the House. Rather, on January 8, 1982, AT&T and Justice filed a consent decree (as a modification of the final judgment entered in 1956 in an 1949 case against Western Electric) that essentially divested AT&T's Bell company local service operations, prevented the Bell companies from entering into competitive markets, and requiring the Bell companies to provide "equal access" to AT&T's long distance competitors.

As a result of the divestiture decree and its amendments, Judge Harold Greene had a major influence over the course of America's telecommunications industry from 1982 until the decree was repealed by express provisions of the Telecommunications Act of 1996,[40] a period of 14 years.[41] He was often referred

[40] Public Law 104-104, section 601 (February 8, 1996).

[41] Between 1984 and 1996, there were numerous Congressional efforts to end judicial control of national telecommunications. As early as 1986, the "Dole Bill" would simply have lifted the decree out of Judge

to as the "telephone czar" in the press, particularly when he made rulings that changed the shape of the industry, such as whether the Bell companies could provide information services. (He said no and was reversed on appeal.[42])

The key lesson for Congress with respect to the interchange fee debate is that a judicial remedy to unlawful activity at the center of a major services industry may lead to uncertainty and doubt over multiple years. Neither policymakers nor the parties to the litigation may be in ultimate control, as district and appellate judges provide their *controlling* perspectives on the appropriate form of relief. Consequently, the MPC believes it is prudent for Congress to provide a framework for relief with respect to the antitrust issues raised by the card associations' price fixing activities.[43]

D. Visa and MasterCard cannot avoid liability simply by criticizing remedies.

In their various public statements, Visa and MasterCard routinely claim that there is no alternative to collectively-set interchange fees—and if there is no alternative, logically there can be no antitrust liability arising from their use. This is simply not true. Remedial options exist and thus the card associations should choose: on-going and growing antitrust liability, or something else chosen by someone else.

Mr. Chairman, it is beyond dispute that consumers, merchants, and the payment card industry all need each other. In today's world, none could function without the others. In the not too distant future, we would like to think that a well-reasoned solution is possible. In the absence of such a solution, consumers and merchants will continue to press their claims in the courts, here in Congress and, not surprisingly, to anyone who may be able to give them relief from this illegal, pernicious practice. By the same token, the payment card associations will continue to steadfastly deny any wrongdoing and instead tout the benefits of their services to merchants and consumers alike and, of course, seek any shelter from this storm they have had now faced for over a decade.

Speaking on behalf of several million merchants, we sincerely appreciate the Committees' interest here today and stand willing and able to work with you and the Committee on this important public policy issue.

Green's court and placed jurisdiction squarely with Congress and the FCC. See F. Henck and B. Strassburg, *A Slippery Slope,* at 252 (1988).

[42] *United States v. Western Electric Co.,* 900 F. 2d 283, 321 (1990).

[43] This "race" between Congress and the court to solve the "Bell problem" is well documented in Steve Coll's 1986 book, The Deal of the Century. These events from the Bells perspective is also found in Peter Temin, *The Fall of The Bell System* (1987).

18 July 2006

The Honorable Senator Arlen Specter
The Honorable Pat Leahy, Ranking Member
Senate Judiciary Committee
224 Dirksen Building
Washington, DC 20510

RE: Credit Card Interchange Rates: Antitrust Concerns

Dear Chairman Specter and Senator Leahy,

As non-profit and non-partisan consumer and public interest advocates, U.S. Public Interest Research Group, Consumer Federation of America and Consumer Action strongly encourage the Senate Judiciary Committee's investigation into credit card interchange rates. We would be happy to come in and brief you or your staff at your convenience on this important matter affecting consumer prices.

Credit card associations' deceptive and anticompetitive practices have injured both consumers and merchants for many years. Interchange fees are hidden charges paid by all Americans, regardless of whether they use credit, debit, checks or cash. These fees impose the greatest hardship on the most vulnerable consumers – the millions of American consumers without credit cards or banking relationships.

The purpose of our three organizations is to advocate on behalf of all consumers for a fair and competitive marketplace. We regularly advocate before state and federal regulators and legislators on competition policy issues.[1] We recognize that financial service markets work best where there is vigorous competition protected from anticompetitive practices. The work of your Committee in overseeing enforcement of the antitrust laws plays a vital role in this important goal.

Based on our experience in these and other markets we believe there are two essential elements to a competitive marketplace: information and choice. Accurate and transparent information is necessary for consumers to make accurate choices. When information is readily available consumers can make choices, effectively compelling firms to compete for their purchases. And choice is a necessary element too. Absent choice, the discipline of the market will be lost.

Unfortunately, the credit card market lacks both choice and adequate information. It lacks choice because merchants have no choice but to accept the card associations' cards even when the associations significantly increase prices. It lacks adequate information because the

[1] For example, see also see the joint testimony of U.S. PIRG and the Consumer Federation of America, by Edmund Mierzwinski, Consumer Program Director, U.S. PIRG, before the House Committee on Energy and Commerce, Hearing on The Law and Economics of Interchange Fees, Subcommittee on Commerce, Trade, and Consumer Protection, February 15, 2006.

associations prevent merchants from accurately informing consumers of the costs of credit card acceptance or attempting to direct them to more efficient and lower priced payment mechanisms. Moreover, the banks and associations engage in other deceptive practices to increase the interchange problem. Since the costs of accepting cards are passed on in the overall costs of goods, all consumers – affluent, working-class, and poor – ultimately pay these hidden charges. Low-income Americans, most without bank affiliations, are paying more for goods and services to fund credit card company programs for which they are not even eligible.

We present four main points. First, all consumers, even those who pay with cash and checks, pay more at the store because these interchange fees are passed on in the overall cost of goods sold. Second, the significant increases in interchange fees signal a broken market. Visa and MasterCard have tremendous market power, which allows them to dictate the terms of trade: merchants have no choice but to accept Visa and MasterCard products on the sellers' terms. Third, there is a lack of information for consumers because the associations' rules limit the ability of merchants to direct consumers to the safest, lowest cost, and most efficient forms of payment. In addition, both the associations and banks engage in a variety of deceptive practices to drive consumers to higher-cost forms of payment. Finally, interchange and consumer fee increases have occurred as banks have merged and industry concentration has increased to alarming levels.

Interchange Fees Force Consumers to Pay Higher Prices

The interchange fee system is hidden from consumers and the public. The card associations do not disclose publicly their fees or the basis for these fees. Some public reports maintain that, on average, interchange fees cost merchants 1.6 percent or more of each transaction on a credit or signature debit card. In 2004, credit card interchange fees alone cost merchants and consumers an estimated $27.6 billion.[2]

Like all other costs incurred by merchants, interchange fees are included – at least in part – when pricing goods and services. Card associations may suggest that interchange fees fund attractive rewards programs. Setting aside the question of the value of these programs, many consumers with credit cards do not use them and those without credit cards receive no benefits.[3] Over 27 percent of Americans do not have credit cards. For these consumers, interchange fees are an especially pernicious and regressive cost.[4] These low-income Americans subsidize interchange fees for "services" that they are not eligible to use. No charge could be as regressive as one in which low income consumers receive no benefits.

The regressive nature of this charge is exacerbated because interchange fees are assessed as a proportion of overall sales. For example, when gas prices averaged $1.87 per gallon in 2004, interchange fees totaled about $12.5 million per day. In 2005, gas prices averaged about

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[2] Food Marketing Institute. "*Hidden Credit Card Fees: The True Cost of a Plastic Marketplace*" (February, 2006).
[3] We seriously doubt consumers receive anything close to $27 billion in benefits through rewards programs. Some of the interchange fees undoubtedly fund industry marketing efforts, such as the more than 5 billion annual mail solicitations consumers receive for credit cards. Moreover, credit card issuance is a tremendously profitable line of business.
[4] U.S. Census Bureau, *Statistical Abstract 2006*, Table 1176.

$2.75 per gallon nationally: credit card companies then made $18.4 million a day. These companies made an additional $2.2 billion dollars per year simply because of rising gas prices.[5] This problem will skyrocket as gas prices continue to increase. It is difficult enough for low and moderate income consumers to afford skyrocketing gasoline prices without having to pay additional fees that are passed on to them.

Increases in Interchange Fees Signal a Broken Market

Credit card interchange fees were intended to compensate card-issuers for certain costs, such as the costs of issuance, fraud, risk of loss, float and processing. Yet as all these costs have decreased in the past decade credit card interchange fees have increased. According to the Food Marketing Institute (FMI), these fees have increased over 20 percent in the past few years even though all the costs of card processing and issuance have fallen. The United States appears to be the only country in which credit card interchange fees are increasing and it has far higher fees that almost any other industrialized country. FMI projects that these fees will increase 22 percent annually.[6]

In a competitive market, prices would fall when costs decrease. In the credit card market, the opposite happens. The card associations may say that they need to increase interchange fees to compete for the loyalty of card issuers. But what about merchants and consumers? Merchants certainly have no choice but to accept Visa or MasterCards.

In the Justice Department case against Visa and MasterCard, the Court determined that both associations had market power because merchants were compelled to accept these cards even in the face of a significant price increase. Almost all merchants are forced to accept Visa and MasterCard's terms, no matter what the interchange rates or contractual terms. Armed with this advantage, credit card companies can, and do, increase interchange fees without suffering any repercussions.

Are these substantial interchange fees necessary? Examples outside the United States suggest this is not the case. In other countries, interchange rates are about one-third less than they are in the United States. In the United Kingdom, merchants pay about 0.7 percent. After a government mandated reduction in interchange fees in Australia from 0.95 to 0.55 percent, Australians saved over $300 million US per year.[7] In the United States, where interchange fees are considerably higher, the potential savings for each consumer would be far greater.

Another example is the debit market in Canada. In that market, there are no interchange fees. Even without interchange, there is higher debit card usage and merchant acceptance than in the United States. Some consumers pay direct fees for debit card use but because those fees are

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[5] Margaret Webb Pressler, "Card Companies Are Filling Up at the Station," in Washington Post. September 25, 2005: pg. F01.
[6] Food Marketing Institute, "Hidden Credit Card Fees: The True Cost of a Plastic Marketplace" (February, 2006).
[7] "An Interchange Tussle With a Twist: Retailers Against Zero Pricing," *Digital Transactions*, September 10, 2004.

transparent there is active competition to reduce those fees. Ultimately everyone in Canada pays less for the cost of payment services.[8]

Deceptive Practices Increase Prices for Consumers

As we suggested earlier, accurate and complete information serves a critical role in making sure the forces of competition work. As the government does not regulate or compel disclosure of credit card interchange fee, most consumers have no idea that they exist and that they are paying for services that they may not even use. In fact, Visa, MasterCard and the card issuing banks engage in a variety of practices to prevent well-informed consumers from exercising their choices.

First, Visa and MasterCard rules prevent merchants from disclosing fees to their customers or attempting to steer consumers to lower-priced payment options, such as cash or online debit cards. They cannot charge a distinctive price or surcharge based on payment options. They cannot attempt to direct consumers to lower cost options such as cash, checks and online debit.

Second, card associations and banks use misleading marketing to encourage consumers to use their credit cards or signature debit cards as frequently as possible. Reward incentives, such as frequent flier miles, are designed to seem as though customers are paid to use these cards. In reality, these consumers and other consumers are simply paying for those rewards.

This lack of disclosure is especially problematic with the recent efforts of the card associations to "convert" cardholders from regular credit cards to so-called "premium cards" such as the Visa "Signature" or the MasterCard "World" cards. These cards have a significantly higher interchange fee than traditional cards, among the highest of all interchange fees. For example, a premium card may cost merchants over 1.8 percent compared to 1.6 percent for a traditional card. These premium cards focus only on the highest-income consumers. However, they offer minimal additional benefits. Consumers do not realize they pay higher prices on goods and services with a premium card and are wholly unaware of how converting to a premium card will ultimately cost all consumers more. Nor, as stated above, can merchants refuse to accept these cards or attempt to direct consumers to lower priced cards through differential pricing. These premium cards are simply a scheme to substantially increase hidden interchange fees.

Third, although merchants can't surcharge or use differential prices to direct consumers to the most efficient and lowest priced payment options, banks do have that power. Not surprisingly, they use it to direct consumers to less efficient, higher cost options. The debit card market illustrates this problem. Signature based debit is more expensive and less secure than online debit because online debit transactions are instantaneous. Online debit has a far lower rate of fraud. Online debit transaction interchange fees are capped at fixed levels; they only cost

[8] Gordon Schnell and Jeffrey Shinder, "The Great Canadian Debit Debate," *Credit Card Management*, May 2004. http://www.constantinecannon.com/pdf_etc/TheGreatCanadianDebit.pdf.

merchants $0.17 and $0.50 per transaction.[9] Conversely, credit and signature debit cards cost merchants up to 2% of the entire transaction, no matter how large. Instead of promoting online debit, banks often surcharge these transactions as much as 50 cents a transaction. These penalties effectively steer consumers to the less efficient, less secure, more costly signature debit product. While the use of online debit cards is the best option for both consumers and merchants, deceptive and manipulative tactics ensure the most expensive payment possible is used.

Not surprisingly, outside the United States, where these anticompetitive practices are not permissible, online debit is the most preferred form of debit. Online debit is a far safer and more secure product. Where market forces are not restrained and consumers can make fully informed choices, the lower priced more efficient product prevails.

.Increased Consolidation of Card-issuing Harms Consumers

The credit card issuing market has become significantly more concentrated over the past few years as numerous card issuers have merged. For example in the past few years we have seen mega-mergers such as BankAmerica's acquisitions of Fleet and MBNA. The top ten card issuers now have over 90% of the market, and the level of concentration has increased from an HHI of about 1100 in 1998 to an HHI of about 1800 today, a level that the Department of Justice Merger Guidelines define as highly concentrated.

Of course, we expect the card associations and their members to suggest that the market is unconcentrated and vigorously competitive.[10] But the facts are to the contrary. While concentration has increased dramatically over the past seven years, interchange fees, other fees charged to consumers, and interest rates have increased significantly. Although the parties to these mergers suggested that there would be significant efficiencies from these mergers, consumers have seen few, if any, benefits.

Conclusion

In his testimony in February on behalf of the Electronic Payments Coalition, Timothy Muris alleged that "[i]f consumers understood the threat that the merchants' campaign [against interchange] poses to the plastic in their wallets, I suspect that we would see nothing less than a revolt." He could not have been more wrong. If consumers understood the existence or the dimensions of the hidden fees assessed by the banks and associations, they would truly rebel. Credit card companies make billions of dollars each year through interchange fees, which ultimately consumers must pay, including the millions of Americans without credit cards. The

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[9] November 2004, Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees, page 11 See http://www.federalreserve.gov/boarddocs/rptcongress/posdebit2004.pdf (last visited 14 February 2006).

[10] In his testimony from February, former FTC Chairman Timothy Muris testified that "[n]o [card] issuer has market power, and issuers respond to increases in interchange fees by enhancing card benefits to consumers." We doubt that Visa and MasterCard or card-issuers act as benevolent monopolists, but in any case there is no systematic study to suggest that increased interchange is passed on to consumers in greater benefits. Even if this allegation was substantiated, it would still be true that all consumers, including those who do not use credit cards pay for those "increased benefits."

credit card market lacks the critical foundations of healthy competition – choice and adequate information. As consumer advocates, we are gravely concerned about the fairness and legality of bank schemes to increase credit and debit card fee income. We urge your Committee to suggest that we follow in the steps of the Australian government and the European Union in carefully investigating interchange fees. We look forward to working with you in protecting consumers from anticompetitive tactics in this vital market.

Thank you for considering these remarks. If you have any questions, please contact us.

Sincerely,

Edmund Mierzwinski
Consumer Program Director
U.S. PIRG

Travis Plunkett
Legislative Director
Consumer Federation of America

Linda Sherry
Director, National Priorities
Consumer-Action

APPENDIX

US PIRG

The United States Public Interest Research Group (U.S. PIRG) serves as the federal lobbying office for the state PIRGs. State PIRGs are non-profit, non-partisan consumer, environmental and good government watchdog groups with over 500,000 members around the United States. U.S. PIRG places a special emphasis on predatory financial practices and financial education and maintains a website at www.truthaboutcredit.org for consumers to obtain non-partisan information and fact sheets about credit card company practices. U.S. PIRG has recently testified on credit card interchange fees (House Energy and Commerce, February 2006) and credit card company practices (Senate Banking, May 2005). Recent major PIRG reports on credit card practices include the following: Graduating Into Debt: A Survey of On-Campus Credit Card Marketing In Maryland (2004); Deflate Your Rate: How To Lower Your Credit Card APR (2002) and The Credit Card Trap: How To Spot It, How To Avoid It (2001).

Consumer Federation of America

The Consumer Federation of America is non-profit organization of approximately 300 organizations (representing 50 million individuals) that, since 1968, has advanced the consumer interest through research, advocacy, and education. Comprised of approximately 300 nonprofit organizations from across the nation and more than 50 million individuals, CFA has been the voice of consumers since 1968. CFA is particularly concerned about issues affecting low and moderate income consumers.

Consumer Action

Consumer Action is a national non-profit advocacy and education organization designed to serve consumers through the advancement of consumer rights. Founded in 1971, Consumer Action has built its reputation based on its multilingual education and advocacy efforts, particularly in the fields of credit, banking, privacy, insurance, and utilities. Along with its advocacy programs, Consumer Action provides educational and technical assistance to more than 6,500 community-based and government agencies in order to ensure access to consumer education. Staff and leaders of Consumer Action are often called upon by the media to provide expert commentary on consumer-based issues. Consumer Action also operates The National Consumer Resource Center (NCRC), which educates and informs clients about current consumer issues.

Bill Douglass

Chief Executive Officer

Douglass Distributing Co.

On Behalf of

The National Association of Convenience Stores

Before the

U.S. Senate Committee on the Judiciary

On Credit Card Interchange Rates: Antitrust Concerns?

July 19, 2006

Good morning, Mr. Chairman and Members of the Committee. My name is Bill Douglass and I am Chief Executive Officer of Douglass Distributing Company. My company, which is headquartered in Sherman, Texas, operates 15 convenience stores and supplies gasoline and diesel fuel to other retail locations in the Dallas-Fort Worth area.

I am here today representing the National Association of Convenience Stores (NACS). NACS is an international trade association representing the convenience store industry. The industry as a whole includes about 140,000 stores in the United States, sold 145.8 billion gallons of motor fuel in 2005, and employs about 1.5 million workers across the nation. It is truly an industry for small businesses; 60 percent of convenience stores are owned by one-store operators. NACS helped found the Merchants Payments Coalition, which includes about 20 trade associations from diverse industries, to help promote a more competitive and transparent system of credit card interchange fees.

I want to thank you, Mr. Chairman, and the Members of the Committee for holding this hearing. Credit card interchange fees hurt my customers – who, in the end, pay for them – and hurt my business. The rise in these fees in recent years has

made them the third highest operating cost for my business and for my industry as a whole. Only payroll and rent cost more than these fees.

As difficult as this cost is to bear for my business, I know these fees are a terrible burden for my customers – and most of them do not even know these fees exist and take money out of their pockets. I compete with other retailers to try to make my prices attractive to customers. But when these fees are tacked on, prices don't look as attractive. This is a big problem in my industry. We put our prices on the street for everyone to see. No other industry so completely and transparently empowers customers to shop for the best price without even leaving their cars. And our customers are perhaps the most price sensitive of all. They will drive far out of their way just to save a couple of cents per gallon on gas. Well, right now credit card companies charge about 5 cents in interchange on a gallon of gas purchased with their cards. That is a big number; when it is tacked onto our prices it hurts our customers and our business. For many of our customers that is nearly $2 **per fill up** that goes straight to Visa and Master Card banks. These charges are an outrage, especially at current gasoline prices.

Just one look at a list of the interchange fees that are charged when a consumer fills up any of several 2006 American-made SUVs and pick up trucks shows how bad this problem has become. And this list doesn't include all the older models of cars or trucks with large gas tanks, vehicles that are used millions of times a day by small businesses or by farmers, but it does give you an idea of how much more in credit card charges have come directly from consumers' pockets in just the last 2 years simply from the increase in the price of one product, gasoline.

Model	**Type**	**Gas tank (gallons)**	**Interchange fill-up (gas=$3per gallon)**
Chevy Suburban (three quarter ton model)	SUV	39	$1.9110
GMC Yukon (XL) 2500	SUV	39	$1.9110
2006 Ford F-350 Lariat 4x4 SD Crew Cab	Pickup truck	38	$1.8620
2006 Ford E-350 Super Duty	Van	35	$1.7150
GMC Sierre (Longbox)	Pickup truck	34	$1.6666
Chevy Silverado (Longbox)	Pickup truck	34	$1.6666
2006 Dodge Ram 3500 SLT (Mega Cab)	Pickup truck	34	$1.6666

Interchange fees are just like an excise tax or sales tax getting added to the cost of our product. But at least people know that taxes are part of their purchase because taxes get discussed publicly and folks get to vote based on their views about whether it is worth it to increase prices with taxes. Unfortunately, the credit card companies won't even let me know the different rates that I can get charged for taking their cards so there is no way for me to inform my customers . . . and they are left in the dark. They have no say in this increase in the cost of everything they buy. I hope that the Committee's hearing can begin to raise some awareness about what is happening.

I want to emphasize that the market by which interchange fees are set is broken and something must be done to fix it. The courts have said that Visa and MasterCard have market power and I will tell you that the agreements among their member banks to fix and charge the same fees are outrageous. While I am not a lawyer, I know I can't agree with my competitors about what I will charge because it is against the law. That should be just as true for banks. Not only that, but the only type of competition that does exist is when Visa and MasterCard compete by raising, not lowering, their fees to get more banks to issue their cards. Competition ought to work in the opposite direction – and does when customers know the facts and have some bargaining power. We don't have either one. They keep us almost

completely in the dark about the fees and their rules and we have no bargaining power with these dominant companies.

The card companies and banks have said that merchants like me want price controls. There is something odd about that claim because the only people who have raised it are credit card companies and banks. I haven't asked for it, and I haven't heard any other retailer or trade association ask for it. I would also note that we already have price controls because Visa and MasterCard members banks fix prices and all agree to charge the same thing. Maybe that is why they talk about it -- because they have experience with their own price controls.

In our view, the Congress does not yet have enough information about these fees to come up with a solution to this problem. As I'll explain, the card associations have worked hard to keep these fees and their operating rules secret. In fact, they have lobbied very hard in both the House and the Senate against proposals for simple studies of these markets and their behavior. The result is we all need more investigation and information before we can prescribe the right solution. The bottom line is this: The situation is as bad as I can imagine right now. Just about anything you could do would be an improvement.

With that in mind, I want to explain four basic points that lay out how dire the situation is for us. First, retailers have no choice about whether they accept cards because of the market power of Visa and MasterCard. Second, the card companies use their power in the market to raise fees and keep the fees and their rules secret. Third, these fees hurt consumers and tend to hurt lower income consumers worse than others. Fourth, U.S. consumers pay a lot more for interchange than most other countries, with no justification whatsoever.

1. Retailers Have No Choice

Over 60 percent of today's motor fuel sales are paid for with credit or debit cards. That is a staggering number. It means one simple thing – I have to take these cards or I will go out of business. I have no option.

The comparison that fits is with the old AT&T – before the breakup. Visa and MasterCard's dominance is very similar to the dominance of Ma Bell before the breakup of AT&T. And protestations by Visa and MasterCard that merchants do not need to accept cards rings just as hollow as someone saying we could just choose not to have telephone service. It simply ignores how business is done in this country. Accepting cards is as necessary as having a phone and other basic

utilities. And the numbers show that the vast majority of consumers use either Visa or MasterCard. Together they have about 80 percent of the market. As recently as 2003, the Second Circuit Court of Appeals held in the U.S. Department of Justice's case against Visa and Mastercard that the two card associations – both jointly and separately – had market power. When we pay the fees we are paying now, all of us know Visa and MasterCard have market power.

When prices rise, consumers are more likely to use a card to pay for goods. This is exactly what has happened in my industry. As gasoline prices increased and the cost of the average fill-up went above $20 or so, card usage rose dramatically – averaging 12.5% increases in dollar volume in each of the last 3 years.

Maybe this is because U.S. consumers get more than 6 billion mail solicitations for credit cards each year. That is more than 20 solicitations for every man, woman and child in our country. And then there are the phone calls. I was somewhat offended to hear Tim Muris testify in February and try to somehow attack retailers by talking about the Do Not Call rule. Well, I don't know about you, but if anyone was interrupting my dinner hour with telemarketing calls it was to give me credit card offers. I appreciate Mr. Muris' work on that rule and just wish he had done something about the junk mail his clients send me.

No matter how we ended up with all these cards, though, the prevalence of them makes this market completely different than other "two-sided markets" that the card associations like to talk about. No newspaper, for example, has the nationwide dominance that Visa and MasterCard have. And newspaper executives do not meet to agree on the rates they will charge for advertising – yet that is just what some banks do as members of Visa and MasterCard. The market choices and competitive pricing in these other industries make them different than the market for cards. But with merchants captive to Visa's and MasterCard's market power, the normal market checks on price increases just aren't there.

There are many situations in which people have no choice but to accept cards though the fees charged do not make sense or are contrary to good public policy.

One example is what happens in the wake of hurricanes and other disasters. This is a big concern because many retailers work hard to open and serve people quickly after disasters. That was certainly the case last year after Hurricanes Katrina and Rita, among others. After these disasters, many retailers had to operate without electricity and phone service or with only limited service. But they got an unpleasant surprise. The credit card companies charged them among

the highest interchange rates possible because without electricity or phone service retailers could not swipe cards or call to get preauthorization before completing a transaction. Retailers had to use paper, carbon receipts or whatever means they had to do business, but they – and, ultimately, the consumers who were hit so hard by the hurricanes – had to pay the exorbitant, higher rates. These rates were almost 60% more than standard rates. Some retailers asked the card associations to waive interchange fees in the affected areas, but these requests were ignored or refused.

In fact, the credit card companies even charged interchange on the stored value cards that FEMA gave to hurricane survivors to allow people to make basic purchases after Hurricane Katrina. Again, many of these fees were at the highest rates because of the limited phone and electricity services in the area. It made no sense to hurt the people and businesses that suffered in these disasters by adding what amount to penalty charges.

One other thing I need to address is the card companies' talk about the benefits of cards to retailers. The point here is not whether credit cards should be eliminated because they have no benefit, the issue is how the card companies are inappropriately taking advantage of their market position to extract far more in fees than can be justified. And while the card companies say that individual purchases

are higher due to credit cards, they have never done a scientific study to determine whether that is real or is just a byproduct of people with higher incomes having and using more credit cards. Without a controlled study, their claims have little factual foundation. Plus, common sense tells us that their claims are not true for things like gasoline sales. Simply put, consumers do not buy more gasoline just because they have a credit card.

2. Card Associations Drive Up Fees and Keep Them and Their Rules Secret

The card companies are effectively controlled by their member banks and the member banks must agree to charge the same interchange rates. As I mentioned, the only competition is by the card companies to raise the rates to get banks to issue more of their cards. Recent changes in the governance structures at Visa and MasterCard have not changed this basic problem. The supposedly "independent" directors at Visa are appointed by member banks. This means the member banks still have effective control of the organization. MasterCard has similar problems. Its public offering was structured to allow member banks to maintain effective control. In fact, the member banks still name some of the members of MasterCard's board. None of this is real change.

The Committee, courts, and antitrust lawyers can debate the legal technicalities of this system, but I will tell you that it makes no sense and is costing consumers a lot more than it should.

American consumers paid more than $26 billion in interchange fees in 2004. That is more than double what the card companies charge consumers in late fees and more than six times what they charge for ATM fees.

The average convenience store paid about $39,730 in credit card fees in 2005. That same store only made $42,196 in **pre-tax** profits in 2005. The fact that businesses in my industry are paying almost as much to the credit card companies each year as they are making before they pay Uncle Sam gives you a sense of just how broken this market is.

I cannot overstate how difficult this is for business and how rapidly the card companies have increased how much money they take on every gasoline purchase. Between 2004 and 2005 the card companies' take from convenience store sales increased 145% more than the convenience stores' take. This has meant that the card companies are quickly taking away our businesses. After expenses and taxes,

they make more money on each sale than we do. In effect, I am working for the card companies.

It is shocking what Visa and MasterCard will do to drive up rates. For example, in May 1998, Visa announced that it would increase its offline debit interchange fee by about 20 percent. The increase was to take effect in April 1999. In November 1998, however, MasterCard announced a 9 percent increase (also to take effect in April 1999) that was enough to keep its fee higher than Visa's. In most competitive markets it would have been a chance for MasterCard to hold or lower prices to gain market share – but the reality is just the opposite when both card brands enjoy merchant acceptance of over 98 percent. In fact, those increases were just the start. In January 1999, Visa announced it would increase its fee by an additional 6 percent. Then MasterCard announced another increase five days later. All of these increases were made before the first rate increase even took effect. When the dust finally settled, Visa's rates went up 26 percent and MasterCard's went up 17 percent. Overall, these increases alone cost U.S. consumers an additional $300 million per year.

All of this is made far worse because Visa and MasterCard have designed the system to hide these fees. The operating rules enforced by Visa and MasterCard

members prohibit disclosing interchange fees on receipts and include a web of rules – including prohibitions on discriminating between types of cards – that effectively keep consumers and retailers in the dark about interchange fees.. This conspiracy enforced by the credit card companies to keep information from consumers is a key element of the problems in this market. How can consumers possibly decide what is in their interest if the card companies keep this information secret?

As a retailer, I do not get a full disclosure of my rates. I understand that the card associations have a complex set of over 75 interchange rates that vary based on the type of card used and many other aspects of the transaction – but I have never seen the schedule of rates in all my years doing business. The rates can range from about 5 cents plus 1.15% for each transaction to 10 cents plus 2.7% of the transaction. But I have no way to know why I get charged a particular rate for a particular transaction. I am simply left to figure out what I have lost based on my own accounting.

Not only are the rates hidden from me, but so are the rules that affect my business. MasterCard has a summary of its rules on its Website. Immediately following a House Energy and Commerce Subcommittee hearing in February, Visa put a

summary of its rules on its website as well. But both summaries are clearly inadequate – leaving out hundreds and hundreds of pages of rules – and do not give retailers the information they need.

Just prior to this hearing, of course, Visa announced that it would make its rules available to retailers on the Internet starting September 1st. But that doesn't tell you the whole story. They plan to let you see the rules only if you have a merchant number and accept Visa. That seems sensible at first, but as a practical matter what it means is that you can't see the rules that you have to agree to until after you sign an agreement to follow them. What would happen if I treated my customers that way and only told them what they were buying after they paid for it? I wouldn't last too long. Not only that, but Visa isn't going to let retailers print the rules. We will have to read more than 1,000 pages on the computer screen. I sure hope that something on page 900 doesn't refer to something on page 100 – or I might just crash along with my computer. On top of all that, we will only be able to see the rules under Visa's plan if we sign a non-disclosure agreement. That means to see the rules I will have to agree not to tell this Committee or anyone else what is in them. I won't be able to tell my trade association about the rules and get advice about what they mean and how to react to them.

This plan may have made a good press release for Visa, but it will keep the shroud of secrecy over this market. Coming five months after Tim Muris testified that the rules were already available on Visa's and MasterCard's websites, this doesn't give me the impression that the card companies are taking seriously the concerns that have been raised about the anticompetitive market of interchange fees.

I want to assure you that these secret rules negatively impact consumers and businesses every day. In my industry, the best example of this – or perhaps I should say the worst example – is something called "reason code 96." This code has come up for retailers of motor fuels when a purchase exceeds $50 for a Visa transaction or $75 for a MasterCard transaction. With the gas prices we have had lately, exceeding these limits has become more common. But Visa and MasterCard say somewhere in their hidden rules that if a gas purchase exceeds these pre-approved levels, they can deny payment to the retailer for the entire transaction. This is true even if the consumer pays and does not dispute the bill. Visa and MasterCard banks have refused to credit retailers' accounts for the entire $51 or more for many of these transactions. Yet, this rule is never disclosed to retailers – they just have to accept that Visa and MasterCard are essentially granting themselves a license to steal the retailer's money. The chart shows just how these so-called "chargebacks" jumped and stayed much higher than previous

levels after gasoline prices rose last fall. This rule, as well as its secrecy, is abusive and inexcusable.

3. These Fees Are Bad for Consumers

Let me emphasize that this is very unfair for our customers because they end up paying for it. The average American family paid $231 in interchange and related fees in 2004. And that is true whether or not that family uses a single credit or debit card. Because these fees are hidden in the cost of virtually everything we buy, even cash-paying consumers ultimately pay for them.

Consumers who do not have credit or debit cards – often because they have lower incomes or poor credit – have to pay for this just like people who have credit cards. But these folks don't get a line of credit or any other benefits for it. In February, Ed Mierzwinski testified on this topic on behalf of the U.S. Public Interest Research Group and the Consumer Federation of America. He said:

> "As consumer advocates, we are gravely concerned about the fairness and legality of bank schemes to increase credit and debit card fee income, especially because an underlying bank goal is also to encourage greater consumer use of plastic payments. As more consumers pay with plastic instead of cash, due to bank incentives such as rewards cards, but merchant fee income is buoyed by potentially anti-competitive practices, all consumers will pay more than we should at the pump, and more than we should at the department store, even

> those of us who still pay with cash. This is especially troubling as a matter of public policy due to the estimated 10-12 million unbanked American families forced to absorb these higher costs even though they pay with cash."

Mr. Mierzwinski was exactly right. The card companies like to tout the rewards they give their customers, but we should be sure to recognize that the *vast* majority of consumers do not get rewards or airline miles with their cards. Convenience store customers who use cards, in fact, only use a rewards card for about 1 out of 7 transactions. And what about the annual fees, interest payments, late fees, and multiple other charges that credit card holders must pay directly? Just more profits for the credit card companies who get consumers coming and going. The bottom line, of course, is that those who get the least from the system pay for those who get some benefits. This is like a secret, regressive tax and this aspect of the problem must be taken into account.

One of the reasons this problem has become so dire is that it is kept secret. ATM fees provide a good comparison. Some have advocated for strong limitations or even abolition of ATM fees. Yet interchange fees are about six times higher than ATM fees. The difference is that consumers see the ATM fee every time they pay it. That gives them some awareness and some ability to change their behavior to

minimize these fees. That doesn't happen with interchange fees because of the card companies' efforts to keep them hidden.

4. The United States Pays Far More Than Its Share of Interchange Fees

Why should Americans pay higher prices to use plastic than consumers pay in other countries similar to ours? As you can see in chart 2, U.S. interchange fees average 1.74%, while other industrialized countries such as Britain typically pay 0.7% and Australia averages only 0.45%. The difference translates into hundreds of dollars in added costs to the average American family annually for no added benefit.

It's the same Visa and MasterCard everywhere – in fact in Britain, according to a report Visa commissioned on interchange, has a higher per capita incidence of credit card use than we do, so clearly low interchange rates haven't hurt Visa and MasterCard at all. We have the highest overall volume of transactions, which should lead to significant economies of scale and lower interchange rates. We also have the best technology for processing these transactions and we have very low rates of fraud. Yet U.S. rates are higher than in other countries and they are rising – while the rates in most other countries are flat or declining.

It is one thing for us to pay about double the rate paid in places like Great Britain, the European Union, and Australia. The credit card companies will spend a great deal of time complaining about the regulatory systems in those places. Of course, they typically don't mention that the rates were far higher here than in any of those places even before their regulators took action. But how can anyone think it makes sense for us to pay higher interchange rates than people in Malaysia or Brazil? Does the United States really have a riskier and costlier credit system than those countries?

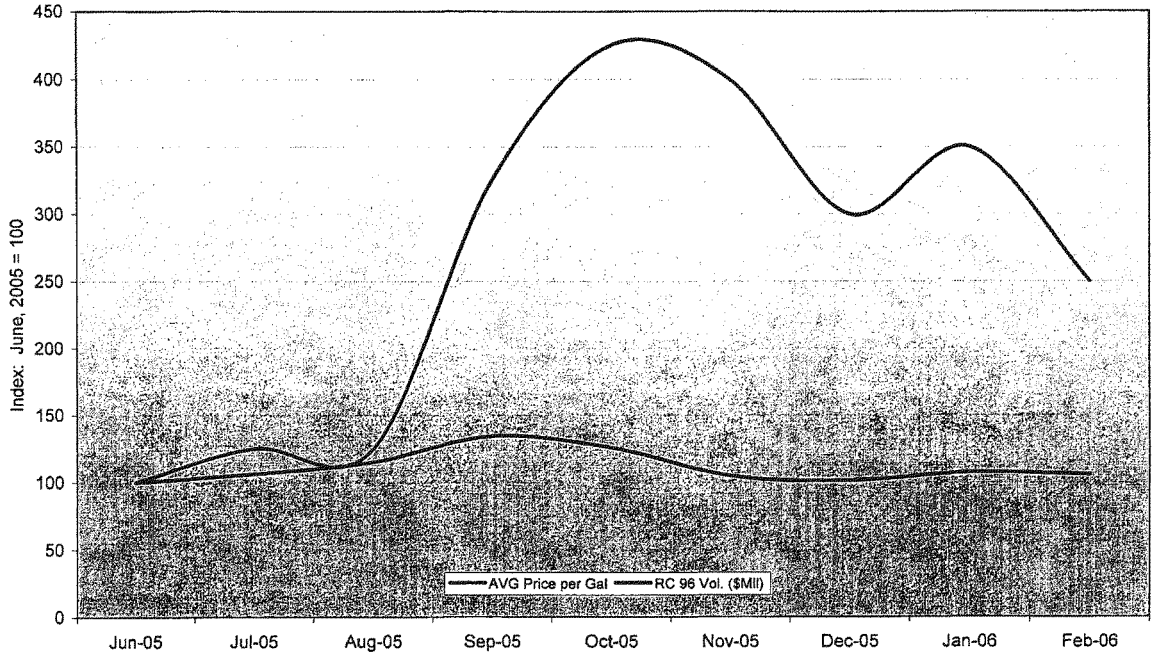
We don't of course, but the anticompetitive problems with this market that I have described allow the card companies to get away with charging more here – so they do. The result is that the United States pays 60 percent of all of the interchange fees collected around the globe. That is simply wrong.

* * *

In truth, this is just a brief glimpse of the problems with this market. We and the Congress need to know more about it so that we can design the right ways to fix it. I look forward to working with the Members of this Committee and the Congress to do just that. I welcome your questions.

How Bad Are Reason Code 96 Chargebacks?

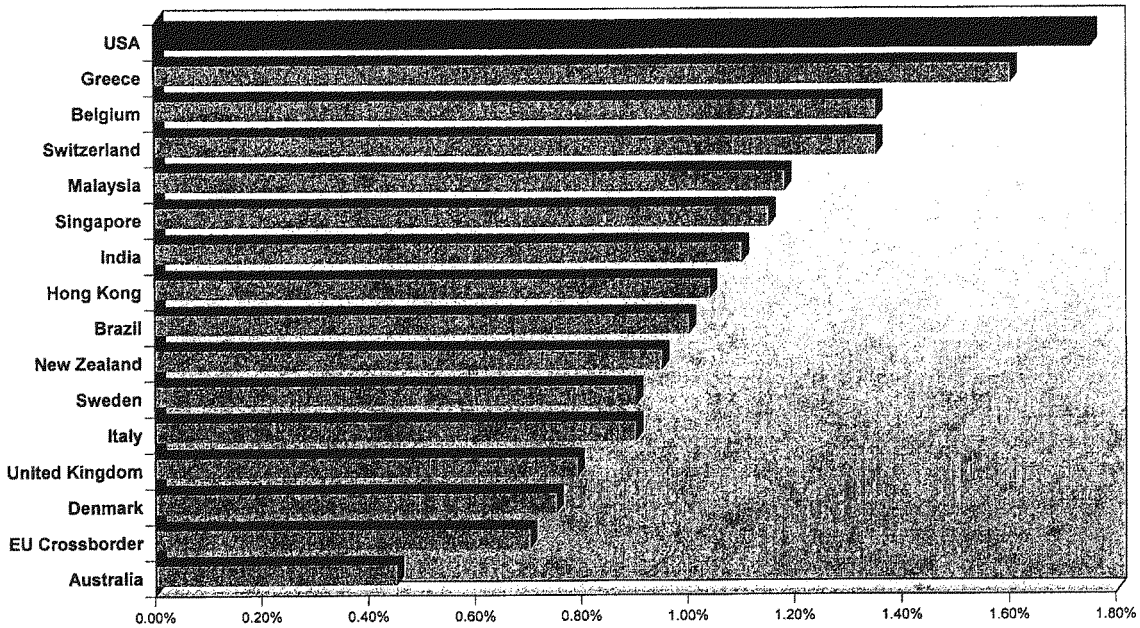
Change in Reason Code 96 Volume vs. Average Price per Gallon since June, 2005



Source: EIA, Fifth Third Bank - NPECA 2006

CHART 1

International Interchange Rates
(Visa & Mastercard)



Source: 2001-2006, TransAction Resources

CHART 2

Testimony of Joshua R. Floum

Before the Senate Judiciary Committee

Interchange Fees: Antitrust Concerns?

* * *

Chairman Specter, Ranking Member Leahy, and Members of the distinguished committee, my name is Josh Floum and I am the General Counsel and Executive President of Visa U.S.A. Inc. I want to thank the committee for giving me the opportunity to answer the question posed by this important hearing.

I. There Isn't a Problem Here

The setting of interchange on four-party payment systems, like Visa, MasterCard and, more recently, American Express and Discover, does not raise an antitrust issue. I recognize that my unqualified "no" to the question posed by this Committee is something of a statement, coming in the midst of approximately 50 lawsuits claiming the contrary. I want to assure this Committee that we take the concerns that retailers have expressed in the litigation and express here today seriously, but I believe that the particular legal claims alleged by the merchants involved in these suits have no merit. As I will touch on in a moment, the fact that interchange and antitrust claims are in the Courts is an additional reason why this Committee should not entertain the idea of artificial price controls.

You will hear the former chair of the Federal Trade Commission Timothy J. Muris lay out the legal and economic case for interchange fees today in his testimony. I agree with the things that Tim has to say, but I want to approach the issue from a slightly different perspective. I am not here today as a law professor or a legal theorist. I am Visa's General Counsel, and in that position, my interest in Visa's legal problems is fundamentally pragmatic. Whenever Visa finds itself the defendant in litigation, I have two questions: (1) why have we been sued and (2)

what, consistent with our legitimate business interest, can we do to resolve this dispute. Having applied this approach to interchange, I have come to the conclusion that the fight about interchange fees is not a legal issue, antitrust or otherwise. It is a business dispute, and it should be and, I believe, will be resolved at the negotiating table.

II. Merchants Derive Enormous Value from the Visa Payment System

Cash and check are, relatively speaking, inefficient ways of exchanging value. Cash is costly to move from place to place and can be stolen or counterfeited. Checks combine many of the inefficiencies of cash with time-consuming authentication procedures at the point of sale. Over the past thirty years, Visa has worked with merchants to build a safer, more efficient and more reliable alternative. Visa's value to merchants is reflected in the structure of its interchange rate system.

Electronic payments offer all sorts of benefits. Many leading economists as well as the Courts have described the Visa payment system and other electronic payment methods as among the great innovations of the 20th Century. Before the cell phone, the personal computer and the Internet, Visa and other payment networks helped transform how people live their lives and how commerce is conducted. With a Visa card, a cardholder can get access to her finances just about anywhere, anytime. Visa cards speed people through the check-out line and give merchants access to the credit that banks supply to their customers. They have also created new channels of commerce that enable merchants to transact business more efficiently on new technologies, with e-commerce and automated fuel dispensers the two most visible examples.

Merchants have played an important role in the development and extension of the Visa payment system. When Visa was trying to build a national payment system to rival American Express in the 1970s, merchants were important partners. Visa offered smaller merchants, which

had not traditionally offered lines of credit to their customers, the opportunity to compete with the likes of Macy's, Bloomingdale's, Nordstrom and other large department stores that used credit as a way of attracting customers into their stores. With Visa members offering cardholders the convenience of a single card accepted at many locations and at lower rates than those offered by the big department stores or American Express, Visa quickly attracted cardholders. And with lower discount rates than those featured by American Express and Diner's Club, Visa quickly attracted merchants as well. This expansion of the payment system fostered competition in another important way, too. Thousands of community banks and credit unions gained the ability to offer a payment card product that could compete directly with the offerings of large national financial institutions.

Visa is continuing to work with merchants to improve the efficiency of the payment system. In the late 70s and early 80s, Visa created a special interchange rate for electronic transactions that gave financial institutions an incentive to move their merchant customers from inefficient paper-based authorization to electronic authorization. That work continues today, even with the overhang of the interchange litigation. Visa and Wawa, for example, recently teamed-up to introduce contactless payments throughout the Wawa chain. As Howard Stoeckel of Wawa observed when this program was announced, Visa's contactless payment platform gives Wawa "customers a faster and easier way to pay, which helps simplify their daily lives."

Visa's close work with merchants is reflected in its interchange rate structure. As Visa's network has expanded from boutique retailers, restaurants and other travel-and-entertainment type merchants to near ubiquity, Visa has recognized that different types of merchants derive different levels of value from their participation in the Visa payment system. Supermarkets, for example, have long been bastions of cash and check. In order to make Visa an attractive option

for such merchants, Visa has set low interchange rates for the supermarket category. E-commerce merchants, by contrast, derive enormous value from payment cards, and Visa's rates for that segment are higher than the rates for the supermarket category. Visa's pricing, like all companies in a market economy, is value-based, based on the costs of supply and the value of demand.

III. This Isn't a Fight About Principle; It's a Fight About Price

Against this backdrop, the debate about interchange seems misplaced. Merchants, even the relatively small group that is sponsoring the current litigation, do not dispute the benefits of electronic payment. Instead, they want the Federal government to cap the price that they pay for these valuable services. Plain and simple, the retailers and merchants behind these lawsuits want to use the current antitrust litigation to reduce their cost of electronic payments and to shift those costs to consumers.

It is important to understand that within the Visa system, financial institution members provide value to two different stakeholders: merchants and cardholders. This Committee must be mindful not only of the interests of merchants in your States, but also the interests of consumers who use Visa payment cards, as well as the many banks, thrifts and credit unions that issue those cards.

Over the years, Visa has provided enormous benefits to cardholders, and these benefits are just as important to us as those we provide to merchants. Visa services allow cardholders to access credit and deposit accounts, and give them zero liability protection. Although Visa itself does not set fees or interest rates, annual fees and interest rates on revolving credit balances have declined across the industry because of the competition that Visa has fostered. In addition, card issuers frequently offer rebates, airline miles and other benefits to encourage cardholders to use

their cards. Visa has also responded in a meaningful way to consumer concerns about overextension or misuse of credit products. Visa pioneered the debit card category in the United States, introducing the first debit card in the 1970s, Debit cards, of course, directly access cardholders' deposit accounts and do not carry interest charges. Today, more than half of Visa's transactions are debit, rather than credit.

Consumers will lose the most if the prices merchants pay for electronic payment services are artificially depressed. As we all know, price controls in any industry have many unintended consequences. You are hearing today from merchant representatives, and we take their interests very seriously, but we also must balance the exchange of value between the merchant's and the cardholder's bank so we continue to promote the interests of the cardholder. Interchange fees play a key role in balancing the exchange of value between cardholders and merchants. If price controls push prices to merchants down, prices to consumers will very likely go up.

Price controls are a severe tool which should be used, if at all, only in the case of real market dysfunction. When a market is not functioning properly, and there is monopoly-type behavior, one would expect output to be restricted and prices to be pushed up. Neither is the case within the Visa system. Merchants in the United States today pay a lower rate to accept general purpose payment cards than they did a half-century ago when those cards were first introduced. The rate on the country's first generally accepted payment card system, Diner's Club, was 7%. Today, the average merchant discount on the Visa system hovers at around 2.2%. Value in the form of access to consumers, efficiency at the point of sale and reliability of the system, however, has sky-rocketed over this period. This means, quite literally, that merchants are paying less and getting more. And the vast majority of merchants are not unhappy with the status quo.

And of course there is no evidence of output restriction. Quite the contrary. There are more cardholders who use the cards and merchants which accept them than ever before. In the past three years, more than 100 million additional Visa cards have been put in the hands of U.S. cardholders, and the number of merchant outlets accepting Visa has grown by more than 900 thousand. Over this same time period, the number of Visa transactions and purchase volume on the Visa network have each seen annual growth rates in excess of 15%, and cumulative growth of more than 50%, as more cardholders and merchants move away from cash and check. The system continues to add new cardholders and new merchants every day, and more and more volumes are moving to Visa's enhanced credit, debit, and commercial products. Hardly the symptoms of restricted output or an unhealthy marketplace.

Nevertheless, we recognize that a small minority, claiming to represent the entirety of the merchant community, is upset. From our perspective, this unhappiness is misdirected. Consumers are driving the increase in payment expense that merchants see on their expense reports by migrating away from cash and check to electronic payments. However, this expense is more than made up to merchants by the increased value to them of electronic payments in place of cash and check transactions. Further, merchants have a real opportunity to control their costs. They can, for example, make different choices about which payment systems they accept. With Visa, MasterCard, American Express, Discover, First Data, Pay Pal, Debitman, Google Checkout and many others—not to mention cash and check—all vying for business, this is not an industry dominated by one or even a few firms. More merchants could also take a greater interest in the payment choices that their customers make and use their influence over the customers at the point of sale to steer them to the payment system that merchants prefer.

This Committee should not be misled. Visa's interchange mechanism is fundamentally indistinguishable from the cross-subsidies that run between the card issuing and merchant signing sides of proprietary card systems like American Express and Discover, and the many other competitors I have just mentioned. It is also no different than the countless other companies that have to attract two groups of constituents to offer value to either. Payment systems, financial markets, auction companies, real estate brokers, and media companies all use a similar business model. Visa's business model does not implicate the antitrust laws any more than theirs do.

IV. Price Controls Harm Consumers

Price controls often harm the people they are supposed to protect. Lawmakers, regulators and courts in the United States have declined the invitation to impose price caps, but regulators in some parts of the world have not exercised similar restraint. The impact of regulation elsewhere shows that consumers in the United States would in fact be hurt by artificial price controls on interchange.

Three years ago, the Reserve Bank of Australia imposed artificial price caps on interchange fees set by Visa, MasterCard and another bank-owned payment system. The Reserve Bank cut rates by 43 percent, from 0.95 percent to 0.55 percent. The Reserve Bank did not regulate the price that American Express charges merchants or modify the internal transfer that American Express makes from its internal acquiring side to its issuing side (*i.e.*, the American Express "interchange" fee). Nor did it benchmark the total price that merchants should pay to accept four-party payment systems to what American Express charges its merchants.

The regulatory intervention has had precisely the expected effect. Cardholders in Australia are paying more for payment cards than they did before through higher annual fees and finance charges. They are also getting less in terms of reward programs and other rebates. Merchants, meanwhile, have seen their cost of payment card acceptance drop some. But there is no evidence that they have passed this decrease in cost on to consumers in the form of lower retail prices. In fact, the Reserve Bank, which had promised that retail prices would decline as a result of its intervention, has given up trying to prove the existence of the promised decline.

The same thing would likely happen here if the retailers and national chains behind these lawsuits were to get their way. If retailers persuade some arm of the Federal government to cap Visa's interchange rates, annual fees and interest rates will go up, and rewards programs and other benefits will decline. Retailers may see their costs decline, though the decline would be likely be offset by another unintended consequence. The regulatory burden would push volume toward unregulated—and often higher priced—competitors. Large issuers would likely turn to whatever systems were exempted from the rate cap, and those systems would see their volume increase at Visa's expense. Consumers, Visa and the large and small community banks and credit unions that depend on the Visa platform to compete with the industry's financial behemoths would lose out.

Artificial price controls are not the answer, as there can be no denying the tremendous growth and health in the payment markets. The merchants behind these lawsuits may continue to make their antitrust arguments in the Courts, but again we believe the right balance in value and costs as between merchants and cardholders is a business matter, driven by supply and demand in the relevant markets. Indeed, the Courts have specifically looked at interchange in the past, and in each Court decision have decided that interchange does not pose an antitrust problem and

indeed promotes healthy competition, efficiency and innovation. In *National Bankcard Corp. (NaBanco) v. Visa U.S.A. Inc.*, 779 F.2d 592 (11th Cir. 1986), *Reyn's Pasta Bella v. Visa U.S.A.*, 259 F. Supp. 2d 992 (N.D. Cal. 2003), and *Kendall v. Visa U.S.A. Inc.*, Slip. Op., 2005 WL 2216941 (N.D. Cal. 2005), distinguished Courts have all rejected antitrust claims regarding interchange. We expect the same outcome in the more than 50 separate new cases filed by the plaintiff's bar. But the main point here is that plaintiffs can seek their remedy in Court, and there is no need for Congress to intervene in advance of judicial resolution by imposing artificial price controls.

IV. A Word On Transparency

As I mentioned at the outset, Visa takes its relationship with its merchant partners quite seriously. In the past years, Visa's most senior executives have made a point of getting out to the merchant community and hearing their concerns directly. We have heard merchant's concerns about the transparency of our operations and governance, and Visa has taken concrete steps to address these concerns.

Retailers have argued for the last several years that they are subject to Visa's rules but do not have access to those rules and, thus, cannot determine whether they have complied with them As a legal matter, this argument makes little sense since Visa's rules do not apply to merchants or, for that matter, to cardholders. Instead they only apply to Visa's financial institution members. Merchants are bound by the contracts they sign with financial institutions to accept Visa cards, and they have every right to demand that those financial institutions explain the obligations that they have assumed by signing up to accept Visa cards. But formalities aside, we have heard the complaint, and we have acted. Beginning in September, merchants that want to

see the rules will be able to get a copy. We are proud of our network, and happy to include merchants among those who have access to our operating regulations.

In keeping with good governance, Visa has also diversified its Board of Directors. Visa is organized as a non-stock membership corporation and throughout its history, its Board of Directors has been made up of people drawn from the executive ranks of its member financial institutions. Earlier this year, Visa amended its by-laws and corporate charter to require that a majority of the Board be independent of the Visa membership. These directors have also been given the responsibility of setting interchange rates. The first group of independent directors has joined the Board, and they have assumed responsibility for setting rates.

* * *

In the past thirty years, Visa has built the most efficient, reliable and secure payment system in the United States. We are very proud to be part of driving this Country's economic growth, and delivering tremendous value to cardholders and merchants. With no indication of market dysfunction and with more cardholders and merchants participating in the system every day, there is no antitrust problem and no reason for this Congress to intervene in a healthy market. Mr. Chairman, I wish to thank the Committee for giving me this opportunity to address it and I am prepared to answer any questions which you might have.

INTERNATIONAL ASSOCIATION OF AIRPORT DUTY FREE STORES

2025 M Street, NW
Suite 800
Washington, DC 20036-3309
USA

Telephone: (202) 367-1184
Fax: (202) 429-5154
E-mail: iaadfs@iaadfs.org
www.iaadfs.org

July 26, 2006

Chairman Arlen Specter
Ranking Member Patrick Leahy
United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Specter and Leahy:

On behalf of the International Association of Airport Duty Free Stores (IAADFS), I am writing to thank you for holding the hearing last week, "Credit Card Interchange Rates: Antitrust Concerns?" This is an increasingly important area of concern to our members.

IAADFS is an international trade association with nearly 500 member companies in the United States and throughout the world. Our members include manufacturers and distributors of products that are sold in duty free stores, as well as companies that operate hundreds of duty free stores in airports, on cruise ships, at border crossings, in free zones, in other duty free areas, as well as on international flights.

Many of the products sold in duty free stores are luxury items that carry higher price tags, and the fact that international travelers are making the purchases in duty free stores means that credit cards are heavily used, both for convenience and to avoid hassles with carrying cash and exchanging currencies. As you are no doubt aware, Visa and MasterCard member banks set the interchange fee that is collected as a percentage of each credit or debit card transaction. However, many consumers are not aware of this interchange fee and how this fee ultimately results in higher costs for goods and services regardless of whether payment is made by credit card, debit card, cash, or check.

We know from colleagues in Europe and Australia that interchange fee reform can be a reality and can allow consumers to make more informed choices about their payment alternatives. On behalf of our association members and our industry as a whole, we appreciate your investigation of interchange rates, the methods by which they are set, and the effects these rates have on consumers.

Sincerely,

Michael Payne
IAADFS Executive Director

Statement of
The Honorable Patrick Leahy
United States Senator
Vermont

July 19, 2006

Statement of Senator Patrick Leahy,
Ranking Member, Committee on the Judiciary
Hearing On "Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

First, I must thank Vermont State Representative, Warren Miller, and his wife, Kathy, for making the trek down from Elmore, Vermont, in order to be here today. I am always glad to see Vermonters here, and especially so when they are able to help us on the Committee as we struggle with the problems confronting businesses and individuals across the country. Kathy, I look forward to hearing from you, and know that you are speaking for many of the small businesses that make Vermont prosper.

Few of us outside the business and banking communities had probably heard much about interchange fees until recently. Those fees, which retailers pay to the banks that process credit card transactions, are ultimately paid by consumers. We are here today because questions are being raised over whether those fees are too high, and whether they are too high because the associations of banks that handle credit cards are behaving unfairly in the marketplace. Just this week, the European Union's Competition Authority announced that unless Visa and MasterCard change those fees, they will face an antitrust action. This is not an issue that we can ignore.

Retailers tell me that interchange fees represent an increasingly large portion of their costs of doing business. They tell me that they are compelled to raise their prices, and shift some of that cost burden onto their customers. They tell me that all of their customers are harmed, whether they pay by cash or check or debit or credit card, because of the fees that force them to raise prices. They tell me that they have no choice but to accept credit cards – and the fees that go along with them – as more and more customers expect to be able to charge their purchases. And they tell me that the entire fee process is utterly opaque; they have not seen the rules for the interchange systems, and cannot decipher the complicated billing schemes of the credit card companies.

Credit cards do bring many benefits to both retailers and consumers – greater access to consumer purchasing power, more rapid payments, and increased payment options for consumers. And certainly, interchange services are necessary, valuable, and worth paying for. But we need to be sure that the cost of

accepting credit and debit cards does not outweigh the many possible benefits businesses and consumers should be enjoying. We need to bring more transparency to the entire system. We need to take a closer look.

The livelihood of many Vermonters depends greatly on the success of our small businesses. I do not want interchange fees to force smaller businesses, like the village grocery store run by the Millers in Elmore, to take a net loss in order to both accept credits cards and sell the ice cream cones, and cups of Green Mountain Coffee that have helped make their store a Vermont treasure.

# # # # #

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- RETURN TO HOME

PRINTER FRIENDLY VERSION

TESTIMONY OF KATHY MILLER
OWNER, OPERATOR

THE ELMORE STORE
ELMORE, VERMONT

SENATE JUDICIARY COMMITTEE

'CREDIT CARD INTERCHANGE RATES; ANTITRUST CONCERNS?"

July 19, 2006

Mr. Chairman, Senator Leahy and Members of the Senate Judiciary Committee:

Good morning. I would like to say thank you for allowing me to testify today. My name is Kathy Miller and I, along with my husband Warren and daughter Kelly, am the owner of the Elmore Store in Elmore, VT. I am also here today as a past chair of the Vermont Grocers Association and on behalf of the Food Marketing Institute which represents our nation's supermarkets and grocery stores.

We appreciate you holding this hearing and for the opportunity to provide testimony on credit card interchange fees and the antitrust issues they raise. We are pleased that light is finally being shed on the anti-competitive and anti-consumer practices of the credit card companies.

This is the store that we have owned and operated now for 24 years. I am a 5th generation Vermonter with deep roots in Elmore, VT. I am the "Mom" part of the operation. Warren, sitting behind me, is "Pop." Warren was elected to the state legislature in Montpelier 4 years ago. We are not only committed to our store, but our community and the state of Vermont as well.

You may wonder why we do what we do – 7 days a week – 96 hours a week – 364 days a year – to be honest, some days we ask ourselves. But we believe that we can and do make a difference to the people and community that depend on us.

My concern as a small independent store may seem small to you, but it is a huge burden for us and very real.

Credit card fees are collectively set by the card associations and we have no control over them. They are not negotiable and cannot be added on to the consumer's bill. We cannot set minimum amounts to swipe credit and debit cards, that is against the

Visa and MasterCard operating rules, I am told. The fees keep increasing to us and our profit margin sinks down even lower.

Last year in our store, 2005, we did $58,500 worth of plastic transactions. The credit card fees to us (out-of-pocket) were $4,400. Each time a customer swipes their card it costs us, 2.65% + 20 cents per sale. For example, if we sell $10 worth of gas, we make 49 cents and pay credit card fees of 26.5 cents + 20 cents. Or if a bicyclist stops for a bottle of water, it costs 23 cents to swipe the card. You do the math – it hurts.

In our store, we have 2 gas pumps that we own – not subsidized by any big petroleum company. When the price of gas goes up, so does the amount of interchange we pay. Because the fee is a percentage rate plus a flat fee, the banks make more and I must pay more, even though their costs for processing the transaction are still the same.

Last year alone, American consumers paid Visa and MasterCard around $30 billion in interchange fees. These fees are set collectively, in secret, by VISA and MasterCard member banks, who then charge them to merchants. These fees are not negotiable. It doesn't matter which bank issues the card, the fee is the same and the retailer has no choice but to pay it. Of course, consumers don't realize they are paying the fee because merchants are effectively prohibited from informing their customers about them. These fees are reflected in the price of every product purchased at the front end of our store whether or not the customer pays with a credit card. FMI members have seen their costs for these fees rise on average 700% in the past 10 years. These increases have occurred despite the fact that the technology infrastructure is already in place and the volume of transactions has grown exponentially, providing economies of scale. In other areas of my business or any business, as technology advances and volume increases, prices go down, or at least remain stable. But that is not the case with interchange fees because there is no competition.

Since I told my customers I was going to Washington, DC to testify on this issue – I can't even tell you how many of my customers were unaware of the hidden fees.

They swipe their cards and think all is "free" because there is "no charge" to them at all. Obviously we lose money on many small transactions and too much on others – so we have to raise prices – because we can't absorb it all. In the grocery business, we compete by lowering prices, not raising them. I am not a lawyer, but I know this is a huge problem that retailers across the U.S. - large and small - are facing, so I ask that you look into this matter seriously. We have streamlined our business to reduce costs as best we can – maintenance doesn't get done as it should, less money goes out in payroll, but we just can't keep absorbing these fees and survive.

But those rules don't seem to apply to VISA and MasterCard and to the banks that issue cards. One reason is that, MasterCard and VISA have undisputed market power, with over eighty percent of the card marketplace. To the extent they compete with each other, it is a perverse competition. They compete to get banks to issue their cards. The way they do that is by providing them with higher interchange fees, by *raising prices.* In fact, the member banks get to decide collectively on the level of the interchange fee. Since merchants and ultimately consumers have no choice but to pay the fees, there is no constraint on this cycle of increasing fees.

As a result, in the plastic card world, the normal competitive model does not exist. In the plastic card world, as costs go down, fees are driven continually upward without explanation. Interchange fees in this country are among the highest in the developed world. You will hear from other witnesses about what antitrust authorities elsewhere have concluded about interchange. But we don't need someone in the European Union or the United Kingdom or Australia to tell us that something is clearly wrong with the functioning of this market and it needs to be corrected.

Plastic has become the predominant currency in the U.S. economy. More than half the transactions in U.S. stores are paid with a credit or debit card and card companies have positioned themselves to get a percentage of every one of these transactions.

The average supermarket industry profit margin last year was 1.16%. That means a profit of $1.16 on a $100 transaction. The interchange paid to the bank that issued the card on that same transaction is more than that! And when the price of food or gas goes up, so does interchange. Because the fee is a percentage rate + a flat amount, the banks make more, even though their costs are still the same. There is something wrong with this picture.

The reality is that interchange is used to subsidize VISA and MasterCard's expensive marketing programs and promotional schemes that benefit only the most privileged few. These include gold-plated reward programs that only the elite consumers qualify for, a blizzard of direct mail offers pushing cards on those who already have them or those who do not want them, and multi-million dollar event sponsorships designed to push consumers into using the most expensive forms of plastic payment. *Every* consumer, including those paying with cash, pay for these programs without knowing it.

In conclusion, interchange fees in this country reflect a market in which the normal, competitive forces are not working. This flawed market results in interchange fees that are not cost related, and which are intentionally kept hidden from consumers. As a result, consumers do not have the information they need to make sound economic decisions about their payment choices.

I would like to ask you on your next ride home to look and see how many vacant store fronts there are in your small downtowns. Just this last winter alone four closed within a 50 mile radius of us.

Some days I feel like I should just turn in my keys – but too many people count on us. Elmore is a town of 850 people. We are the hub of the community – when someone needs something, who do you call? "Mom" or "Pop" at the Elmore Store. We are just trying to keep our doors open.

I thank this Committee for shining some light on anti-competitive interchange fees and the impact they have on our business and on consumer prices. I would be pleased to answer your questions.

Thank you.

TESTIMONY OF

TIMOTHY J. MURIS

FOUNDATION PROFESSOR

GEORGE MASON UNIVERSITY SCHOOL OF LAW

BEFORE THE

SENATE COMMITTEE ON THE JUDICIARY

CREDIT CARD INTERCHANGE RATES: ANTITRUST CONCERNS?

JULY 19, 2006

Chairman Specter, Ranking Member Leahy, and Members of the distinguished committee, the answer to the question posed by this hearing is, "No, interchange fees do not raise antirust concerns." My name is Timothy J. Muris, and I want to thank the committee for allowing me to discuss this important subject. I am George Mason University Foundation Professor of Law and was Chairman of the Federal Trade Commission from 2001-2004. As you know, I personally advise Visa on antitrust law, including issues related to the setting of interchange fees, but the views that I express today are my own.

My testimony this morning addresses four points. First, I will explain why interchange fee agreements in four-party payment systems, such as Visa and MasterCard, are lawful under the Sherman Act. Second, my testimony will make clear that the Visa and MasterCard networks are not cartels of financial institutions. Third, I will discuss two-sided products and explain why increases (or decreases) in interchange levels are not evidence of market power. Finally, I describe the benefits of payment cards to consumer and merchants, and the likely harm in regulating them.

I. Interchange Fees Do Not Violate the Antitrust Laws

Today's subject is at the heart of what is now the largest private antitrust litigation in the hundred-plus year history of the Sherman Act. Various merchants have filed fifty or so cases challenging the interchange fees of the Visa and MasterCard payment systems. They claim that the practice of setting interchange fees on four-party payment networks, such as Visa and MasterCard, violates Section One of the Sherman Act.

Section One concerns itself with agreements that restrain competition to the detriment of consumers. Since the enactment of the Sherman Act in 1890, the price fixing cartel has provided

the paradigmatic case for Section One enforcement. Merchants attempt to analogize interchange to a cartel fixing prices. They are wrong.

After decades of antitrust enforcement, cartel pricing has become relatively easy to spot. A group of otherwise competing firms simply agrees to fix a price for their otherwise competing products. Basic economic theory explains why such agreements are pernicious. When firms collude to fix the price of a particular product, they deprive consumers of the benefits of competition. Assuming a sufficient number of firms participate, a price fix allows them to raise the price of the product above the level that would otherwise prevail. If a price fix sticks, it deprives some consumers of the product altogether, which results in a net loss to society as a whole, and transfers wealth from those consumers who still purchase the product to the cartel members.

The setting of interchange in a four-party payment card system has nothing in common with this cartel behavior.[1] To understand why, it helps to understand how different payment card systems are organized. Although many people think of American Express, Discover, MasterCard, and Visa as rough equivalents (and, in most important respects, they are), the systems operate much differently. American Express and Discover are three-party systems.[2] A single corporate entity issues cards to cardholders and signs merchants to accept those cards. Consequently, when a three-party payment card is used, the rights and responsibilities all stay within a single corporate family. The entity that issued the card pays the merchants the face value of the transaction, less whatever fee the system charges the merchants. This amount is

[1] There is a voluminous literature on payment cards and the underlying economics, to which I've contributed. The Appendix to this testimony lists some of this literature.
[2] Within the last couple of years, some third party banks have begun issuing American Express and, to a lesser extent, Discover cards.

known as the merchant discount. That same corporate entity then collects from the cardholder according to whatever agreement has been struck.

In contrast, Visa and MasterCard are four-party systems. Here, the payment system itself does not issue cards or sign merchants to accept those cards. The job of issuing cards and signing merchants falls to participating banks, credit unions, and thrifts. When a cardholder of one financial institution—called an issuer—uses a card at a merchant signed by another financial institution—called an acquirer—matters are more complicated than in the three-party systems. The issuer has the right to collect from the cardholder but has no relationship with the merchant. The acquirer has the obligation to pay the merchant but no right to collect from the cardholder. For a four-party payment card system to work, the issuer needs to pay the acquirer for the obligation incurred by the issuer's cardholder. This is where interchange is necessary. Interchange is the word used to describe the rate at which the issuer and acquirer exchange a transaction on a four-party payment card system.[3]

It should now be clear why setting interchange rates in a four-party payment card system does not raise the cartel issues the merchants claim. Unlike the cartel described above, economic theory tells us nothing about what the world would look like without interchange on four-party payment card systems. A four-party payment card system simply cannot exist without interchange. With thousands of issuers and acquirers, and over six million merchant outlets accepting Visa and MasterCard, the absence of a default interchange fee would require in its place millions of bilateral agreements. A set fee reduces these transaction costs of negotiating separate interchange fees between acquirers and issuers.

[3] To the extent that they use third party banks, see *supra* note 2, American Express and Discover offer those banks the equivalent of interchange.

Moreover, for Visa to succeed as a "brand,"[4] merchants need to honor cards from each of the thousands of issuers. Otherwise, consumers would not be guaranteed that their "Visa" card would be accepted widely. Knowing that all cards must be honored, individual issuers could insist on very high fees for the payment cards they issue. Merchants would then be subject to those high fees and would be less willing to accept the entire network. A default interchange avoids this problem. Without this interchange fee, issuers and acquirers would have no way to exchange transactions.

Thus, the difference between a true cartel and Visa is stark. With cartel pricing, an end to the cartel leads to lower prices, higher output, and greater innovation. The end of interchange will instead lead to chaos, and less innovation.

The merchants understand this fact. They do not want an end to interchange. They simply want interchange rates to be lowered. **But this is not an antirust remedy**. If he were to follow antitrust principles, a Federal judge could not mandate a new price fix (albeit at a lower level) as a remedy to a price fixing claim. One of the fundamental maxims of antitrust is that the market, not the government, should set prices. Indeed, "reasonableness" is *never* a defense to a price fixing claim. To set interchange at a reduced rate, however it was ultimately justified, would run directly counter to these core principles of antitrust.

II. Visa and MasterCard Are Not Cartels of Banks

We can expect that merchants will object to this defense of interchange. They will argue that I have omitted a critical fact—that Visa and MasterCard are actually cartels of member financial institutions. This objection has always been misplaced, and it is even less true today.

[4] The same analysis applies to MasterCard.

The company that we now think of as Visa formed in the early 1970s. Visa is a spin-off of Bank of America, which started a three-party payment card system in California in the 1950s. Bank of America wanted to expand its card outside of California to compete with national systems sponsored by Diner's Club and, later, American Express. But banks were prohibited from operating across state lines at the time. In the 1960s, Bank of America first tried to expand by franchising the operation to banks in different states, but it found few takers. Bank of America then spun-off the system level operation in the early 1970s.

That spin-off, renamed Visa, has functioned as a cooperative ever since. The individual financial institution member/owners control the cooperative according to, roughly speaking, their issuing and acquiring volume. They collectively elected a Board of Directors drawn from the executive ranks of the various members. The Board, working with management that it had the authority to hire and fire, wrote the rules and set the rates, including interchange, that made the system work.

Although MasterCard originated slightly differently, it was, until recently, organized almost precisely the same way. Both MasterCard and Visa have now made profound changes to their ownership and governance structures. MasterCard has ceased to be a cooperative. The financial institutions that until recently owned MasterCard have sold a controlling interest in the company to third-party investors, taking the company public through an IPO. Visa is still owned by its member financial institutions, but directors not affiliated with the financial institutions will soon be a majority of its Board. Visa has also announced that those independent directors will have exclusive responsibility over the setting of interchange rates, or any other action with a potential economic impact on Visa members.

III. Interchange Levels Are Not Evidence of Market Power

At this point, we can expect the merchants to change tack again. Because "price fix" and "bank cartel" are empty slogans, the merchants will undoubtedly argue that interchange represents an abuse of market power. Here, too, they are wrong.

Payment card systems are a leading example of what economists and antitrust lawyers call two-sided products. Along with other two-sided products, such as newspapers, exchanges (*e.g.*, auction houses, eBay, NASDAQ, NYSE) and search engines, payment card systems bring together two different groups of customers. A basic understanding of the economics of two-sided products illustrates why the attack on the setting of interchange is flawed, not just as a matter of antitrust law and policy, but of broader public policy as well.

The challenge for the operator of any two-sided product is bringing both sides on board. For payment card systems, the two groups of customers are cardholders, who want access to the financial resources to make purchases anywhere in the world at any time, and merchants, who want to supply those cardholders. The trick for operating a successful payment card system is attracting enough cardholders to make the system appealing to merchants and, simultaneously, attracting enough merchants to make the system appealing to cardholders.

Although the problem is easy to state, it can be devilishly hard to solve, at least in practice. A payment card system could, of course, attempt to attract merchants and cardholders simultaneously by calculating the precise cost of supplying each "side" of the market. Even assuming, however, that these costs could be identified, there is no guarantee that a price based on those costs would appeal to either potential cardholders or merchants.

The pricing strategy employed by most newspapers illustrates how most two-sided products actually set their respective prices. Newspapers and other advertiser-sponsored media

bring together two distinct groups of customers, readers and advertisers. Readers of newspapers pay little or nothing to enjoy the benefits. Instead, publishers collect the vast bulk of their revenue from advertisers. If a newspaper charged readers a price based solely on the direct marginal costs of supplying readers with the paper, it would likely lose readers who, after all, have many other options. Without enough readers, there will not be enough advertisers.

The economics of attracting two distinct groups of consumers drives the pricing strategy for all two-sided products. As we discussed above, the value of a two-sided product to one group of customers is determined by its attractiveness to the other group of customers. This means that the group of customers with attractive low cost substitutes, as are newspaper readers, will always get the better deal. This is not a matter of fairness or cost recovery. It is simply the way that the supplier of the two-sided product maximizes the appeal and the use of the product to both sides.[5]

For payment card systems, at least at present, the consumer is king. Although merchants decide which payment forms to accept, consumers typically decide the payment form to use on a particular transaction. Payment card systems face competition from two historically dominant forms of payment, cash and check, that the federal government subsidizes and that generally carry a low marginal cost to use. To compete, payment card systems have settled on a pricing strategy that directs substantial value to cardholders (*e.g.,* cash-back, rewards, a grace period, and low revolving rates) at no explicit price per transaction. Merchants are charged on all purchase transactions.

[5] *See, e.g.*, Timothy J. Muris, *What's in Your Wallet?*, WALL ST. J., June 24, 2005, at A12 ("These inducements help maximize the joint value of the ultimate transaction for the parties. Rather than an inefficient 'subsidy,' these inducements are the lubricant necessary to make the economic machine work at its best.").

The industry has followed this pricing model from its very inception, before anyone could credibly argue that any payment card system had any conceivable market power. When Frank McNamara kicked off the payment card revolution in 1948 with the introduction of the Diner's Club card, he set the merchant discount on that three-party system at 7% of each transaction. The evolution of the industry from a travel-and-entertainment card carried by businessmen and accepted at exclusive restaurants and hotels has pushed fees ever lower. Today, the average merchant discount on the American Express system is approximately 2.5%, while the system wide merchant discount on the Visa system is about 2.1%. The fact that the larger system, Visa, as measured by everything from merchants to cardholders to volume, has a lower discount should also cast grave doubt on whether so-called market power explains the pricing in this industry.

IV. The Payment Card Systems Are Not Broken, and Interchange Doesn't Need Fixing

As I mentioned previously, the merchants cannot want an end to interchange. Instead, they would like the courts to fix a lower "reasonable" price for a service that they voluntarily accepted and continue to use. The agreements that are in place between card systems, merchants, and cardholders are consensual, not the product of force or fraud. It is hard to imagine how intervention in the form of price regulation could possibly improve matters. Consumers clearly enjoy the benefits of card membership. Payment cards offer consumers greater convenience, reduction of the risk of theft, better management of expenses, improved recordkeeping, float for those who do not revolve balances, and reward programs.

Merchants also derive enormous benefit from payment card systems. Merchants get ready access to bank-supplied credit. They get faster throughput at the point of sale, enabling merchants to sell more product in less time at lower cost. As a result, new merchants are added

to the system almost daily, and the networks are constantly innovating to address the needs of entire merchant segments to attract them to the network. Walk into a McDonald's or Subway now and you can swipe your payment card to purchase a meal. Just a few years ago, few if any quick service restaurants accepted cards. They were not coerced into accepting them now. They began accepting them because the payment systems offered a valuable service for a price they were willing to pay.

That price controls would put all of these benefits at risk is not simply a matter of common sense. We also have empirical evidence, courtesy of the Reserve Bank of Australia. In Australia, the Reserve Bank announced an interchange rate regulation for bank-owned card systems, namely Visa, MasterCard, and Bankcard. In October 2003, the regulations became effective, capping interchange rates at 55 basis points, and allowing merchants to surcharge anyone who chooses to pay with a payment card.

The effects of the RBA's intervention in the payment card markets will play out for many years, but the regulatory regime has already had significant impact. The RBA's mandate has clearly harmed cardholders. Since the imposition of the rate caps, credit card fees have increased substantially. In a recent study of Australia's rate regulation, economists estimated that Australia cardholders had seen their annual fees and finance charges increase by AU$197 million.[6] The value of reward points to cardholders on credit cards have fallen by nearly 20%.[7]

The role of interchange in providing benefits to consumers is crucial to understand. When interchange increases, cardholders benefit. Because of intense competition between the

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[6] *See* Howard H. Chang et. al., *The Economic Effects of Australia's Regulation of Interchange Fee Setting After Two Years*, Fed. Reserve Bank of N.Y. Conference: Antitrust Activity in Card-Based Payment Systems: Causes and Consequences (Sept. 15, 2005), *available at* http://www.newyorkfed.org/research/conference/2005/antitrust/presentations/chang_evans_presentation.ppt.

[7] *See* Philip Lowe, Assistant Governor, Reserve Bank of Australia, Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration, The Australian Payments System (May 15, 2006), *available at* http://www.rba.gov.au/Speeches/2006/sp_ag_150506.html.

many banks that issue payment cards, "higher" interchange revenues to issuing banks result in increased benefits on payment cards, such as increased rewards and lower fees.

This takes me to my final point. The attack that some merchants are waging against Visa and MasterCard poses a direct threat to the American consumer. The current system of interchange fees is a necessary part of an industry that provides enormous benefits to consumers. I have witnessed the full fury of the aroused American consumer. While Chairman of the FTC, I led the agency in riding the wave of public resentment to create the National Do Not Call Registry. I suspect that many Americans feel as strongly about their plastic as they do about their dinner hour.

If the current interchange cases are actually litigated on the merits, the plaintiffs should lose. Nevertheless, the plaintiffs' lawyers and their merchant clients probably assume that they will never have to litigate these cases on the merits. Instead, they probably assume that they will be able to extort a settlement because, by the time of trial, the plaintiffs' stated damage theory could approach $1 trillion after trebling. They will argue for a "pragmatic" solution to the problem, and they are betting that some arm of the federal government will provide the help that they need to succeed. Because the American consumer will be the primary victim of any such solution, I continue to hope that this Committee and the rest of the Federal government has the courage and conviction to turn the merchants away empty-handed.

Mr. Chairman and members of the Committee, that concludes my testimony. Thank you again for inviting me, and I will be happy to respond to questions.

APPENDIX

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National Association of College Stores
500 E. Lorain Street **Oberlin, Ohio 44074**

July 19, 2006

Chairman Arlen Specter
Ranking Member Patrick Leahy
Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510-6275

Dear Senators Specter and Leahy,

On behalf of the National Association of College Stores (NACS), I write to thank you for holding a hearing today on "Credit Card Interchange Rates: Antitrust Concerns?"

Headquartered in Oberlin, Ohio, NACS is the professional trade association representing the collegiate retailing industry. We represent more than 3,200 collegiate retailers and 1,100 vendors. NACS member stores serve nearly 95% of America's 15.5 million college students while supporting the academic missions of higher education institutions.

Americans pay a hidden fee on virtually every transaction they make, whether they use a credit card or not, costing consumers tens of billions of dollars a year. This fee, called interchange, is a percentage of each transaction that Visa and MasterCard banks collect from merchants and others such as institutions of higher education every time a consumer uses a credit or debit card to pay for a purchase. The fee varies with type of card, size of merchant and other factors, but averages close to 2 percent for credit card and signature debit transactions. These hidden fees drive up the cost of goods and services for all consumers whether they pay with plastic, cash or check.

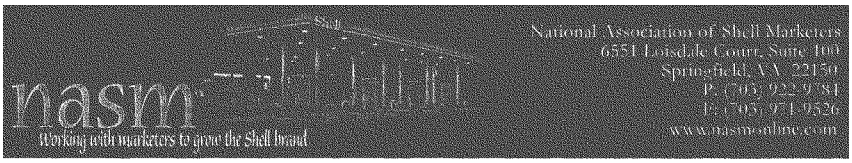
Over the last several years our member have been increasingly concerned about interchange fees. NACS data indicates that credit and debit purchases accounted for 54 percent of student purchases in college stores in 2003-2004, resulting in conservatively an estimated $85 million in interchange fees paid by college bookstores and their student and parent customers.

At a time when students and parents are struggling to pay for college costs, high credit card interchange fees are helping make higher education less affordable for many Americans. I thank you again for scheduling this hearing to closely examine these fees and for your unwavering support of education.

Sincerely,

Brian E. Cartier

Brian E. Cartier, CAE
Chief Executive



July 19, 2006

Chairman Arlen Specter
Ranking Member Patrick Leahy
United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Specter and Leahy:

On behalf of the members of the National Association of Shell Marketers, we thank you for holding the important hearing pertaining to, "Credit Card Interchange Rates: Antitrust Concerns?" The issue of credit card interchange is one of the highest priorities of the members of NASM and the 575 marketers that distribute Shell petroleum products. These companies are independent, small businesses that market a wide variety of petroleum products and convenience store items, and distribute over 70% of the Shell motor fuels marketed in the U.S.

It is important to note, although very few consumers realize it, they pay a hidden fee on virtually every gasoline and convenience store purchase they make - whether they use a credit card or not. For the typical gas station/convenience store operation, the cost of interchange and processing fees can be as high as three percent, a cost to consumers of an additional 9 cents per gallon with prices at $3 per gallon.

The testimony of Mr. Bill Douglass, to be presented to your committee, is consistent with reports we have been receiving from the majority of our members, and illustrates how unjust these interchange fees are.

I would like to reemphasize that it is important for the public to realize that interchange fees drive up the cost of goods and services regardless of whether consumers pay with plastic, cash or check.

We believe Visa and MasterCard control a system that is fundamentally anti-competitive and, perhaps monopolistic, since their member banks collectively agree to charge the same interchange rates. At present, merchants must sign a non-disclosure agreement prohibiting them from discussing the operating rules established by Visa and MasterCard with anyone, including members of your Committee. Therefore, it is time credit card companies are required to explain to the public their fees, practices, and policies.

Thank you for holding this hearing which, we hope, will start the process of bringing these unconscionable credit card fees into the "sunlight" and result in a more equitable system for consumers and merchants.

Sincerely,

Thomas F. West
President

Chairman of the Board: David Adcox, Hohenwald, TN • **1st Vice Chairman:** Gary Garrison, Plainview, TX • **2nd Vice Chairman:** Joe C. Morris, Jr., Ridgeland, MS
Treasurer: Garry Gray, Milford, VA • **Corporate Secretary:** Steve Kirkham, Kingston, TN • **President:** Tom West, Springfield, VA
Legal Counsel: Taylor & Powell, LLC • **Manager, Membership & Administrative Services:** Jennifer Richards

Chairman Arlen Specter
Ranking Member Patrick Leahy
United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510
July 18, 2006

Re: Hearing on Credit Card Interchange Fees

Dear Chairman Specter and Ranking Member Leahy,

I write on behalf of the National Association of Theatre Owners (NATO) to commend your decision to hold a hearing on credit card interchange fees. This hidden charge—imposed on merchants through complex and obscure rules with no relation to any actual cost of service—exacts approximately $65 million a year from our industry and our patrons.

NATO is the national trade association of the motion picture theatre industry. Its members operate over 29,000 motion picture screens located in all 50 states. NATO's membership includes the largest cinema chains in the world, as well as hundreds of independent theatre owners. Historically, our industry has been cash-based, but the percentage of credit card transactions, for both tickets and concessions, steadily rises.

Visa and MasterCard are not subject to any meaningful competitive pressures beyond the stark capacity of merchants and consumers to bear the added cost. Visa and MasterCard member banks collectively set interchange rates—and the exorbitant rates in the United States are among the highest in the world, despite a lower cost of service here. Yes, to answer the question posed by your hearing title, interchange fees in the United States raise jarring "antitrust concerns."

To illustrate just how dramatically the imposition of interchange rates has departed from the model of a healthy, competitive market, consider a recent development on the "transparency" front. Merchants have long operated virtually in the dark about how the interchange rates are determined and applied, along with the myriad additional restrictions and requirements applicable to use of various credit and debit cards. In short, we've been unable even to examine the onerous rules that exact tens of millions of

750 FIRST STREET, N.E., SUITE 1130, WASHINGTON, DC 20002
(202) 962-0054 • fax: (202) 962-0370 • www.natoonline.org • nato@natodc.com

dollars from our industry. The fee is hidden and merchants are blinded—because Visa and MasterCard can.

Now Visa announces a plan to "disclose" the operating rules—subject to a rigorous non-disclosure agreement, and excepting information of a "competitive" nature, and excluding details such as "interchange rates." It is a testament to the arrogant market power of these behemoth banking institutions that such a caricature of transparency could be imagined "progress."

We applaud your resolve to examine this financial pathology that drains away so many billions of dollars.

Sincerely,

G. Kendrick Macdowell
General Counsel and Director of Government Affairs
National Association of Theatre Owners

July 18, 2006

The Honorable Arlen Specter
United States Senate
Washington, DC 20510

Dear Chairman Specter:

As the trade association that represents the interests of America's travel plazas and truckstops, NATSO writes to express the industry's support for the Senate Judiciary Committee hearing on "*Credit Card Interchange Rates: Antitrust Concerns?*" on Wednesday, July 19, 2006. The U.S. travel plaza and truckstop industry employs over 144,700 individuals and sells 75-80 percent of diesel fuel sold in the United States. A typical travel plaza or truckstop sells gasoline and diesel fuel, operates fast food and/or full-service restaurants, sells convenience items, offers free extended stay parking, and might offer truck repair and a host of other services. Most, if not all, of these services are paid for by credit/fleet cards by professional truck drivers and the traveling public.

Use of credit/fleet card purchases continues to increase. Ten years ago approximately 35 percent of diesel fuel purchases were made with credit/fleet cards, while today approximately 80 percent of these same purchases are made via card payment and subject to interchange fees. The credit/fleet card usage rate for independent marketers is closer to 90 percent of their total diesel fuel sales.

Increased fuel prices have resulted in even higher interchange fees. Consumers complain about gas prices now, they would give a huge outcry if they only knew that in many cases the credit card issuers are making more money on a gallon of gas than the gasoline merchant. The average fuel marketer makes a profit of two or three cents per gallon sold, but pays three times that in interchange fees. The public's calls for investigations into price gouging at the pump fail to recognize that the biggest profiteers are the credit/fleet card companies. While businesses and the public are suffering under high fuel prices, credit/fleet card companies are racking in the profit.

It is clear that this hearing before the Judiciary Committee is timely and critical. Thank you for holding this hearing. Please feel free to contact NATSO for further explanation about how interchange fees impact the travel plaza and truckstop industry.

Respectfully,

Lisa J. Mullings
President and CEO

Statement of the National Grocers Association to the United States Senate Committee on the Judiciary

Full Committee Hearing

"Credit Card Interchange Rates: Antitrust Concerns?"

July 19, 2006

National Grocers Association
1005 N. Glebe Road, Suite 250
Arlington, VA 22201-5758
703-516-0700
www.nationalgrocers.org

The National Grocers Association (N.G.A.) greatly appreciates the opportunity to submit this statement for the record of this important hearing before the U.S. Senate Committee on the Judiciary. N.G.A. thanks the Committee for holding today's hearing on interchange, a matter of great antitrust importance to the retail community.

N.G.A. is the national trade association that represents exclusively the interests of independent, community-focused grocery retailers and wholesalers. An independent, community-focused retailer is a privately owned or controlled food retail company operating in a variety of formats. Most independent operators are serviced by wholesale distributors, while others may be partially or fully self-distributing. A few are publicly traded, but with controlling shares held by the family and others are employee owned. Independents are the true entrepreneurs of the grocery industry and are dedicated to their customers, associates, and communities. N.G.A. retail and wholesale members accounted for $200 billion of U.S. grocery sales last year. N.G.A. is a founding member of the Merchants Payment Coalition that is made up of trade associations representing supermarkets, retailers, convenience stores, restaurants, drug stores, gas stations and other businesses that are concerned about increasing interchange fees charged by credit card companies and banks.

An interchange fee, usually in the form of a percentage of the transaction, is charged to the merchant by the card issuing bank and the card association. N.G.A. believes that there are major antitrust problems with the current interchange fee system, causing profound harm to consumers and merchants. For the benefit of the American consumer, federal governmental agencies and members of Congress must exercise oversight of debit and credit card interchange fees and the lack of a competitive market.

I. Interchange: A Market Failure That Harms Consumers and Merchants

Interchange fees charged by MasterCard and Visa, and the rules under which they are levied, are nothing more than a hidden tax on retail grocers and the consumers they serve, including customers using other payment methods who indirectly subsidize cardholders. Interchange fees are hidden from consumers by credit card companies, but consumers ultimately pay them because costs have to be passed along in the form of higher consumer prices. Visa and MasterCard rules require that fees be collected from the merchants, not directly from the card users. These card-based fees are the single most profitable source of income for banks. These fees now exceed $26 billion annually with contracts that actually prohibit merchants from disclosing the cost to their customers who use the cards.

In a competitive marketplace when costs go down, rates should fall. Interchange fees have increased precipitously even though fraud is down and transaction volume is up significantly. This is because debit and credit card systems and their interchange rates are a private, unregulated money system that has exceeded cash and checks as the favored means of paying for goods and services since 2004. The debit and credit card interchange rates of Visa, MasterCard and their member banks are established collusively by the competing banks that constitute the boards of directors of Visa and MasterCard. This is a clear violation of federal antitrust laws. As a result, interchange rates can be increased at will; they bear no relation to any legitimate charges that arguably should be imposed on merchants and consumers.

The interchange system is a clear example of a market failure. No competitive forces exist to pressure the card associations to lower rates. Rather, competition raises

interchange fees as Visa and MasterCard compete for issuers by offering them higher and higher payouts from interchange fees.

Few issues have received the attention of retail and wholesale grocers, as well as all other retail merchants, as that being given to the high and increasing cost of interchange that retailers must pay to Visa and MasterCard for accepting their debit and credit cards. The United States has the highest credit card interchange fees of any industrialized country, and interchange rates have continued to increase even while costs of processing and fraud have declined. The international precedents for antitrust investigation and government intervention are persuasive and demand serious review and appropriate action by this Committee.

A recent Morgan Stanley report found that the weighted average for Visa and MasterCard interchange had increased from 1.58 percent in 1998 to 1.75 percent in 2004 (an increase of 10.8 percent) and is forecast to grow to 1.86 percent in 2010 (an additional increase of 6.3 percent over 2004 and 17.7 percent since 1998). With the growing use of plastic, interchange fees now exceed $26 billion annually and are projected to increase more than 22 percent each year.

The vast majority of grocers do not have the ability to overcome the market power of Visa and MasterCard in order to negotiate lower rates. The results of the recent settlement in 2003 of the Wal-Mart case against the credit card companies clearly illustrate the anticompetitive nature of the interchange system. Visa and MasterCard agreed to pay the plaintiff retailers more than $3 billion, but immediately increased credit card interchange rates to cover the cost of the settlement—and then some.

Except for the very largest merchants, efforts to negotiate lower interchange rates have been rejected, even when retailers have attempted to aggregate. The vast majority of merchants, therefore, have no control over this discriminatory cost of doing business, because it is set by an illegal cartel.

The issue here is about the need for competition, and when it doesn't exist then solutions must be pursued to correct the unfairness and level the playing field. In November 2005 N.G.A., together with some of its members, Affiliated Foods Midwest, Coborn's Inc., D'Agostino's Supermarkets and the Minnesota Grocers Association, filed a class action suit against Visa, MasterCard and a number of banks, alleging the named defendants conspired to fix the interchange fees that are charged to retail grocers and ultimately consumers in violation of the Sherman Act. This action was recently consolidated in the U.S. District Court for the Eastern District of New York with over 47 other actions filed.

One must ask why the United States lags behind other countries in addressing this important issue. Australia in 1998 passed its Payment Systems (Regulation) Act 1998 after an investigation by the Australian Competition and Consumer Commission found against the collective fixing of interchange fees. Consequently, on August 27, 2002, the Reserve Bank of Australia adopted a new cost-based approach to interchange fees and eliminated the no surcharge rule, which prevents retailers from directly charging consumers the cost of interchange when they pay by card. The purpose is to ensure that the setting of interchange fees in designated credit card systems is transparent and promotes efficiency and competition. In the Bank's view, interchange fees in the credit card systems were not subject to the normal forces of competition which pushed fees up,

not down. The Reserve Bank of Australia reported in August 2005 that, "Prior to the reforms, this fee averaged 0.95 percent of the amount spent; it now averages around 0.54 per cent." The Reserve Bank of Australia also found, "In total, as a result of the Bank's reforms, merchants' costs of accepting credit and charge card payments were around $580 million lower than they would otherwise have been. Given the competitive nature of Australian business, these cost savings are finding their way into lower prices for goods and services, or smaller price increases than would have otherwise have taken place." On November 25, 2005, the Reserve Bank of Australia announced further amendments that became effective on July 1, 2006. Some observers predict rates will drop to .35 per cent.

On September 6, 2005, the United Kingdom Office of Fair Trading (OFT) found that a collective agreement between members of MasterCard UK Members Forum (MMF), including most banks, setting the multi-lateral interchange fee paid on virtually all purchases using UK-issued MasterCard credit and debit cards between March 1, 2000, and November 18, 2004, restricted competition and infringed Article 81 of the EC Treaty and the Chapter 1 prohibition of the Competition Act. It gave rise to a collective agreement on the level of the multilateral interchange fee and resulted in unjustified recovery of certain costs.

The OFT found the inclusion of extraneous costs provided a large flow of revenue to card issuers and the incentive to induce customers to hold and use MasterCard cards, for example, through loyalty schemes, advertising and funding the interest-free period. The fee was passed on to the retailers by the merchant acquirers through higher merchant service charges. The OFT stated, "Consumers, including those who do not use

MasterCard cards, ultimately picked up the cost for the higher interchange fee through higher retail prices." Sir John Vickers, OFT Chairman, said, "This unduly high interchange fee was like a tax on UK consumers."

Although the OFT consented to the Competition Appeal Tribunal's setting aside of the OFT's September 2005 decision, the investigation will continue and will include Visa. OFT chief executive John Fingleton stated in June 2006: "We still believe that the interchange fee arrangements that are now in place could infringe competition law and are harmful to consumers, who pay higher prices as a result of these fees. Continuing to defend appeals against the original decision before the Competition Appeal Tribunal diverts us from dealing most effectively with the overall problem of interchange fees. Our resources are better spent in reaching decisions on MasterCard's and Visa's current interchange fee arrangements rather than continuing with these appeals that concern only MasterCard's historic arrangements."

In September 2000, the European Commission challenged Visa's anticompetitive multilateral interchange fee, and Visa agreed in 2002 to lower the weighted average fees in stages to 0.7 per cent in 2007. Numerous other countries, such as Sweden, Italy, Netherlands, Switzerland, Spain, Israel and Mexico have addressed the anti-competitive nature of interchange.

Other countries have addressed and reduced anticompetitive interchange fees, and now it is time for Congress and federal agencies to do the same.

The current interchange system is inherently flawed and presents gross inequities for both retailers and consumers. Transparency is a must. All parties involved, especially consumers and merchants, should be made aware of the interchange fees

charged to merchants, and ultimately consumers. The consumer has a right to know how interchange fees affect the prices of goods and services from merchants. Retailers are charged increased interchange fees to cover the incentives given to consumers to use the cards carrying the highest interchange rates. Those incentives by any objective standard should not be part of every consumer's grocery bill; they should be absorbed by Visa, MasterCard and their card-issuing banks, which reap the majority of the huge financial benefits. It is time to end this "hidden tax" on merchants and consumers, including customers who pay by cash or check and thereby subsidize cardholders.

The present system has another major antitrust flaw in addition to interchange rates: anticompetitive card association rules and procedures. For example, imagine yourself as a retailer who wishes to accept Visa and MasterCard as a means of payment by your customers. You sign merchant agreements in which you agree to abide by all of these associations' rules, but a wall of secrecy and nondisclosure hides them from retailers. Those rules must end.

II. Collusive Setting of Interchange Fees and Operating Rules Violate Antitrust Laws

In the Department of Justice case against Visa and MasterCard, the U.S. Court of Appeals for the Second Circuit found that when Visa and MasterCard pass rules, that is the collective action of a cartel of banks that compete to issue cards or sign up merchants to accept Visa and MasterCard. *U.S. v. Visa U.S.A., Inc.*, 2003 WL 22138519 (2d Cir. Sept. 17, 2003). It follows that the setting of interchange rates by those same Visa and MasterCard banks cartelizes the setting of interchange fees and violates Section 1 of the

Sherman Act. The existing system eliminates any incentive for card issuing banks to lower interchange fees in response to the demands of the merchant community, consumers and other participants in the marketplace.

Visa's and MasterCard's complex system of rules amplify the power of this cartel to maintain supra-competitive pricing by restricting merchants' ability to disclose fees to consumers or charge cardholders a different price based on differences in interchange fees for various cards. For example one rule requires merchants to accept all Visa and MasterCard credit cards despite the fact that interchange rates vary by as much as 100% based on the type of card (Platinum Plus®, Visa Signature®, corporate, small business etc.). The sad consequence of this system is that all consumers, regardless of form of payment, end up subsidizing the rewards of select cardholders. This type of cartel rate setting and rule making are clearly in violations of the Sherman Act.

III. Conclusion

N.G.A. strongly believes that action by Congress and federal agencies is needed to end the anticompetitive and illegal price fixing and discriminatory establishment of interchange rates and card association rules. Interchange fees should be set by competitive forces, not by collusion. In addition, anticompetitive rules which harm merchants and consumers and maintain the market power of card associations must be ended, and retailers must be informed in advance of the rules to which they will be subjected.

N.G.A. applauds the Committee for holding this important hearing and urges Congress to continue to investigate and correct the unfairness of the current interchange system.

REPRESENTING THE RESTAURANT INDUSTRY
The Cornerstone of the Economy, Career Opportunities and Community Involvement

July 20, 2006

Chairman Arlen Specter
Ranking Member Patrick Leahy
United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Specter and Leahy:

On behalf of the National Restaurant Association and its 925,000 restaurant and food-service locations nationwide, thank you for holding the hearing, "Credit Card Interchange Fees: Antitrust Concerns?"

Interchange, a fee that is collectively set by Visa® and MasterCard's® member banks, is a percentage of each transaction, sometimes accompanied by a flat fee, that banks collect from retailers every time a credit or debit card is used to pay for a purchase, adding up to billions of dollars each year. This high cost poses a difficult burden to small businesses and restaurants across the country.

Interchange fees are meant to cover the cost of processing a credit card transaction and the potential risk taken by the issuing bank of a default on payment. The cost of processing a debit or credit card transaction is the same whether you are buying a cup of coffee or a meal at a fine dining restaurant, yet because this charge is levied as a percentage, the higher your bill, the more money goes to VISA and MasterCard member banks. Thanks to technology, the cost of processing these electronic transactions continues to decrease and yet the charges continue to rise and are among the highest in the world. The result is an increase in revenue for the card issuer, and a drain on a restaurant's bottom line.

In the United States, interchange impacts not only the merchants, but has the largest impact on American consumers. This "hidden tax" was estimated to cost the average American household approximately $232 in 2004. This year, the restaurant industry will spend over $3 billion on interchange fees. It is critical that we find a way to slow the out-of-control interchange increases that place undue financial burdens on American restaurants, other merchants and their consumers.

Thank you again for holding a hearing on this important matter.

Sincerely,

John Gay
Senior Vice President
Government Affairs & Public Policy

1200 SEVENTEENTH STREET, NW • WASHINGTON, DC 20036-3097
TEL: 202.331.5900 • FAX: 202.331.2429 • WWW.RESTAURANT.ORG

July 26, 2006

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
224 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Patrick Leahy
Ranking Member
Committee on the Judiciary
United States Senate
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Specter and Ranking Member Leahy:

On behalf of the National Retail Federation (NRF) we want to thank you for holding the hearing, "Credit Card Interchange Rates: Antitrust Concerns?" Credit cards fees affect virtually all of our businesses and every American's pocketbook. Reining in the adverse effects of these price-fixed fees on retailers and our customers, and attempting to reintroduce competition into an industry gone awry is a major NRF priority. The Senate Judiciary Committee's July 19 hearing was an informative and enlightening first step.

By way of background, NRF is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, drug stores and grocery stores as well as the industry's key trading partners of retail goods and services. Overall, NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees -- about one in five American workers - and 2005 sales of $4.4 trillion. NRF's views on this issue are also supported by our National Council of Chain Restaurants division, which represents 40 of the nation's largest multi-unit, multi-state chain restaurant companies that operate more than 50,000 restaurant facilities.

NRF is pleased that the Committee is examining the anti-competitive manner in which interchange fees are set and imposed by Visa and MasterCard. In essence, the card associations have used their market power to turn competition on its head. Rather than competing to set the lowest fees and hold down costs, Visa and MasterCard's idea of competition is to set ever higher rates and fees in order to maximize profits for the banks that issue their cards.

What is perhaps worse is that the fees are set collusively. The banks within Visa and MasterCard have agreed in secret to set the fees they charge: a price-

Liberty Place
325 7th Street NW, Suite 1100
Washington, DC 20004
800.NRF.HOW2 (800.673.4692)
202.783.7971 fax 202.737.2849
www.nrf.com

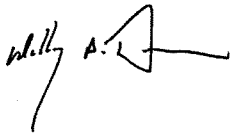
fixing cartel that would be a clear violation of federal antitrust law in almost any other industry. These collusively set fees drive up the price of everything we sell, and take tens of billions of dollars out of consumers' pockets. Unlike other credit card fees that show up on a monthly statement, interchange fees paid by consumers are never revealed to consumers. Visa and MasterCard's non-negotiable contracts require merchants to include the Visa and MasterCard fees in the advertised price of our merchandise; forbid the fees from being shown on cash register receipts; and effectively bar cash discounts.

These restraints are enforced by card association rules, also developed in secret, and are imposed on every retailer forced to accept their cards. And forced they are. In today's economy, retail acceptance of credit cards is nearly as essential as a telephone. Both the courts and practice recognizes this reality. Even beyond the Second Circuit's findings of the card associations' market power, there are fewer, stronger real world indications of just how much market power the card associations wield than the fact that in order to accept cards, some of the largest corporations in America are forced to sign contracts in which the terms imposed upon are not revealed. Visa and MasterCard refused to provide full disclosure of their rates or their rules (essential contractual terms), which leaves NRF members in the dark.

It is time to shed light on these anti-competitive practices. Just as every aspect of this hearing will be made available to the public – from the testimony to the transcripts – it is well past time that the card companies uncloak the practices and policies that adversely affect millions of merchants and consumers. Visa's agreement to the Chairman's request to make Visa's operating rules available to the committee – and, via the committee, to the public – is a critical first step toward transparency and, we ultimately hope, toward competition.

Thank you again for your leadership. We at NRF stand ready to work with the Committee and with Congress on this very important issue.

Sincerely,



Mallory B. Duncan
Senior Vice President, General Counsel

CREDIT CARD INTERCHANGE RATES: ANTITRUST CONCERNS?

TESTIMONY OF JOSHUA PEIREZ
GROUP EXECUTIVE, GLOBAL PUBLIC POLICY &
ASSOCIATE GENERAL COUNSEL
MASTERCARD WORLDWIDE

Before the
United States Senate Committee on the Judiciary

July 19, 2006

Good morning Chairman Specter, Ranking Member Leahy, and members of the Committee. My name is Joshua Peirez and I am the Group Executive, Global Public Policy and Associate General Counsel of MasterCard Worldwide. It is my pleasure to appear before you this morning to discuss the highly innovative and efficient MasterCard system and the role of interchange. Specifically, both have been essential to the transformation of global commerce, which has produced enormous benefits to consumers, merchants, and the economy as a whole, while fostering a high degree of competition among payment systems.

MasterCard is a driving force at the heart of commerce, enabling global transactions and striving to make commerce faster, more secure, and more valuable to everyone involved. MasterCard seamlessly processes close to 14 billion transactions each year. With more than 1 billion cards issued through its family of brands, including MasterCard®, Maestro® and Cirrus®, MasterCard serves consumers and businesses in more than 210 countries and territories, and is a partner to more than 25,000 of the world's leading financial institutions. With more than 24 million acceptance locations worldwide, no payment card is more widely accepted than MasterCard. MasterCard maintains a competitive infrastructure that drives business growth for merchants and banking customers alike.

It is important to note that MasterCard itself does not issue payment cards, nor does it contract with merchants to accept those cards. Those functions are performed by our customer financial institutions. The financial institutions that issue payment cards bearing the MasterCard brands are referred to as "card issuers." The financial institutions that enter into contracts with merchants to accept MasterCard cards are referred to as "acquirers." MasterCard provides the networks through which these financial institutions interact to complete payment transactions and sets certain rules regarding those interactions. Often, MasterCard's rules are "default" rules, meaning that they apply only if the financial institutions do not otherwise reach alternative arrangements among themselves. This is true with respect to interchange.

Healthy Competition

For many decades cash and check have been the primary forms of payment in the United States. In the last few years, however, the payments business has evolved more rapidly than at any other time in history. We fully expect this evolution in payments preferences to continue as

merchants and consumers are increasingly seeking and using new forms of payment from payment cards, to electronic checks, to virtual currency.

MasterCard competes against all of these forms of payment, including paper-based transactions (such as cash and checks), electronic transactions such as wire transfers and ACH payments, and other electronic forms of payment, including card-based payment systems. Within the general purpose payment card industry, we compete vigorously worldwide with brands such as Visa, American Express and JCB, among others. In the United States, we also compete with other brands such as Discover/Novus. Within the debit segment, we compete with ATM and point-of-sale debit networks in various countries, such as Plus, Electron, Interlink, PULSE, Star, NYCE and Debitman in the United States, Interac in Canada, and EFTPOS in Australia. In addition, we compete against businesses that issue their own private-label payment cards such as retail stores and large petroleum companies.

In addition to our more traditional competitors, we also have competitors that have developed rapidly growing alternative payment systems such as PayPal and payments effected via mobile devices, such as cellular phones, transponders and other handheld electronic devices. Among other things, these competitors provide Internet currencies that can be used to buy and sell goods online, "virtual checking" programs that permit the direct debit of consumer checking accounts for online payments, and services that support payments to and from proprietary accounts for Internet, mobile commerce and other applications. Finally, we compete intensely for the loyalty of our financial institution customers and for their merchant and cardholder customers.

Tremendous Benefits to Consumers

Consumers have a wide variety of choices of payment methods at the point of sale—in a store, on the phone or online. Consumers can pay with cash, check, debit card, charge card, credit card, prepaid card, merchant-issued cards of many types, PayPal and many other alternative payment systems. Even among the types of payment cards, consumers have thousands of options for the provider of those cards and the benefits associated with their use. Regardless of the form of payment, consumers obviously find value in the form they choose to use.

MasterCard Payment Cards Offer Convenience and Consumer Protections

MasterCard payment cards offer consumers significant benefits and convenience. Individuals carrying a MasterCard payment card know they can walk into an establishment almost anywhere in the world and make a purchase using their MasterCard card. In fact, MasterCard cardholders can transact in more than 150 currencies without the need to exchange cash. A MasterCard cardholder can travel the world with only a single piece of plastic and make payments without the need to carry large amounts of cash or travelers checks. A MasterCard cardholder can buy everything from groceries to medical services on a MasterCard card.

MasterCard cardholders can use MasterCard cards at millions of merchants. That means fewer trips to the bank or ATM and the security that comes with not having to worry about carrying the right amount of cash, losing it, or having it stolen. Our popular advertising

campaign says it best: "There are some things money can't buy…for everything else, there's MasterCard." In essence, MasterCard's role at the heart of commerce is an integral part of the globalization that has fueled our economy over the last forty years.

In addition to the protections that MasterCard provides, consumers receive a wide variety of protections under the Truth in Lending Act (TILA) and Electronic Fund Transfer Act with respect to their payment cards. These protections include unauthorized use liability limitations, rights requiring banks to investigate and correct billing errors, and expansive disclosures to ensure that consumers fully understand these and other rights. MasterCard cardholders also receive a convenient, detailed accounting of their spending through periodic statements provided by their card issuers, which helps them to keep track of their purchases and manage their expenses. Furthermore, under TILA, credit cardholders receive protections from liability when they use their cards to pay for goods that are defective or that the merchant fails to deliver. Credit cardholders also can obtain what is essentially an interest-free loan for the period between their purchase and when their payment for that purchase is due to their card issuing bank.

Payment Cards Fuel the Internet

MasterCard cardholders need not even leave the comfort of their own home to shop around the globe. For years, cardholders have made purchases through catalogs delivered right to their home. Now, the Internet has become a powerful tool for consumers to find the lowest prices on a myriad of products. The rapid development of e-commerce is due largely to a cardholder's ability to pay for a product online by using a payment card. Furthermore, MasterCard is developing, and intends to continue developing, new and innovative payment options and features related to Internet purchases.

Consumers Benefit from Competition in the Marketplace

Aside from convenience and security, MasterCard cards also offer consumers significant, tangible benefits. These include airline miles, reward points, cash back offers, and a variety of other benefits. The proliferation of these key benefits is the direct result of intense competition in the payment card industry and the payments market generally. Not only does MasterCard compete with other forms of payment, but MasterCard issuers compete vigorously against each other and other payment card issuers. Because consumers can literally pick from thousands of different payment cards, issuers strive to make their payment cards more innovative and appealing to consumers. This intense competition has resulted in the elimination of annual fees for many types of payment cards and a reduction in cost to consumers seeking the value and convenience they provide. The increase in rewards and loyalty cards is also a direct result of healthy competition in the marketplace.

Substantial Benefits to Merchants

Merchants Have Choices in a Competitive Marketplace

Merchants derive enormous benefits from this competition, including the ability to provide an unprecedented number of payment options to their customers. For example, a single merchant can now offer its customers the choice to pay by cash, check, credit card, charge card,

off-line or on-line debit card, proprietary card, installment loan, ACH, PayPal or a growing number of other means. Even with all these options, merchants prefer to accept certain types of payment, or only certain brands, and are free to restrict payment options in their stores (as many merchants do). They can also offer a variety of payment options but steer their customers to the preferred methods, which many merchants routinely do, for example when they prompt a consumer to enter a PIN on a debit card transaction. Merchants who prefer to receive payment by cash have many options as well, such as requiring payment in cash or providing incentives, such as cash discounts, to encourage their customers to use cash in lieu of other payment forms. This ability to offer cash discounts is unambiguous and easily implemented via signs at the cash register stating, for example, "discount of XX afforded to customers paying with cash."

Merchants Choose Payment Cards Because of Superior Benefits

Amidst this wide array of payment choices, merchants have been offering a growing number of payment card options to their customers. This is not surprising when one examines the profitability and other benefits payment cards create for merchants who accept them. For example, the convenience and flexibility payment cards offer consumers means that consumers are likely to spend more than they would if they had to pay with cash or checks. They can make purchases when they are far away from home where they do not have cash, or where the merchant does not accept checks (which most merchants believe to be a risky form of payment). Payment card transactions generally take less time at the point of sale than other forms of payment, so merchants can serve their customers more quickly and efficiently. Payment cards also lack many of the difficult to measure costs associated with the acceptance of cash, such as the risk of employee theft or fraud, or the need to count and transport cash (the costs to society of cash are even more significant). Unlike checks, payment cards offer merchants the benefit of guaranteed payment (subject only to the federally mandated and other consumer rights that could result in chargebacks). Perhaps most importantly, merchants accept payment cards because they, and consumers, prefer to use them. In sum, payment cards offer merchants an extraordinary value. It is therefore no surprise that the number of merchant outlets accepting payment cards continues to increase.

Merchants Invented Payment Cards But Others Provide Payment Cards More Cost Effectively

Merchants were the first to recognize the benefits of payment cards when, in the 1920s, individual merchants began to issue credit cards to their customers. These card programs, known now as two-party systems, grew because they were attractive to consumers given the convenience and ready access to credit they provided while bringing merchants increased revenues and some of the other benefits described above. These programs were not very efficient, however. Each merchant had to conduct its own underwriting to determine which customers qualified for credit. Merchants also learned the difficult lesson that while the availability of credit can increase sales, collecting on that credit can be challenging and expensive. This problem was compounded for merchants in that the borrowers from whom they sought to collect were the very customers from whom they derived their sales—and collection activities generally run counter to retail efforts to create customer loyalty.

Merchants' powerful desire to benefit from payment cards combined with the relative inefficiency of the two-party systems, and the merchants' lack of expertise and operational

infrastructure for lending created opportunity for entry by other providers, and in 1950, a company known as Diners Club introduced the first so-called "universal" payment card that could be used at any store or business that chose to accept it. In 1958, American Express followed suit and offered its own widely-accepted card. Diners Club and American Express both used the three-party system in which a single company issues the cards, signs up merchants to accept the cards, and performs the functions necessary to complete the transactions. These three-party systems have generally been less expensive to operate and more efficient than merchant provided payment cards.

In the 1960s, banks began to use a "four-party" system to offer their own card programs. One group of banks joined forces to create Interbank and MasterCharge (which became MasterCard in 1979). Around the same time, Bank of America licensed a group of banks in the U.S. to issue its BankAmericard (which eventually became known as Visa). These four-party systems created even greater efficiencies and benefits by bringing together the cardholders and merchants of hundreds and eventually thousands of banks to complete transactions. Indeed, the four-party systems are more efficient and often less expensive than the two-party or three-party systems—a result which our antitrust laws are intended to encourage. Small banks and credit unions can also participate and compete in four-party systems so long as those systems have default interchange rates.

Value of Payment Cards Exceeds Costs to Merchants

More and more merchants, especially small businesses, were drawn to these various card offerings as the benefits became more widely known, notwithstanding the costs of acceptance. Indeed, it is worth mentioning here that the costs of acceptance in the early days of the payment card industry were as much as 5 to 7% of the purchase amount, far more than they are today. Merchants of all sizes, especially small- and medium-sized businesses, see great value from the three- and four-party system cards because it is far less expensive and less burdensome than running their own proprietary card programs. It also provides small merchants the opportunity to provide their consumers payment card options and thereby compete with large retailers and gas companies that can afford to offer their own cards. One can imagine the reaction of a merchant who had struggled with the underwriting, administrative, legal, credit risk, and other problems associated with its own credit card when Diners Club offered to perform all of those functions for the merchant's customers. The prospect of guaranteed and timely payment alone (*i.e.*, getting paid for a transaction even if the customer does not pay the bill) was a huge benefit. Thus, merchants quickly recognized that all of these benefits far outweighed the costs of card acceptance and the industry grew.

Interchange Allocates Costs and Value

Since the inception of these three- and four-party payment systems, merchants have paid a fee, called a "merchant discount fee," in exchange for the benefits of card acceptance. In a three-party system, the merchant discount is paid directly to the network that provided all of the services to the merchant. For example, in the American Express system, the merchant discount is paid to American Express, which issues the payment card, licenses the merchant to accept the card, and operates the system that enables the completion of the transactions.

In a four-party system, the merchant pays the merchant discount to the acquirer (*i.e.*, the bank that licensed the merchant to accept the card). A substantial portion of the benefit provided to the merchant by the acquirer, however, is derived from the activities of the card issuers. For example, it is the card issuers that assume the credit losses when the cardholders make purchases from merchants but do not pay their bills. In recognition of these services provided by an issuer in connection with a particular transaction, the acquirer pays the issuer a fee, called an "interchange fee."

MasterCard management is responsible for establishing interchange fees in the United States. Although MasterCard establishes interchange fees and collects and remits them on behalf of our financial institution customers, we do not keep any portion of them. Nonetheless, interchange fees are an important part of the system because they balance the demands of the cardholders and merchants and have been arrived at through intense competition among payment networks and other forms of payment. This is true whether two banks agree to an interchange fee between themselves or rely on the MasterCard system's default rates. Functionally it is the equivalent of what three-party systems do on a balance sheet and what two-party systems do in reality—funding some portion of the issuing activity through revenues earned in connection with selling merchandise.

Setting interchange fees is a challenging proposition that involves an extremely delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. In response to competitive forces, MasterCard management works extremely hard to maximize the value of the MasterCard system, including dollar volume spent on MasterCard cards, the number and type of MasterCard cards in circulation, and the number and type of merchants accepting MasterCard cards, by setting default interchange fees at levels that balance the benefits and costs to both cardholders and merchants. Three-party systems like American Express and Discover set their merchant discounts to establish a similar balance.

Today, on average, merchants pay the highest merchant discount for accepting American Express cards, the lowest for accepting Discover cards, and somewhere in between for accepting MasterCard cards. Interestingly, even though Discover is the cheapest to merchants it is not the most widely accepted or used. Two-party systems or proprietary card programs are much more expensive and less efficient to operate for merchants such that most of these programs are now operated by banks. In fact, two-party systems are so inefficient that even a representative of the National Association of Convenience Stores recently stated in Congressional testimony that any payment system the convenience store merchants could create themselves would be too expensive compared to those of MasterCard and Visa.

Legal Challenges

Groups of retailers and plaintiffs' attorneys have sought to use the courts to attempt to reduce the merchant discount fees by challenging on antitrust grounds the methods by which MasterCard, and its competitor Visa, set their respective interchange fees. To date, these cases have all failed. Generally, these cases allege that because the four-party systems traditionally

involved joint ventures owned by competing financial institutions, the setting of interchange fees by those joint ventures involved a conspiracy to fix prices in restraint of trade. This line of attack was first attempted in the 1980s, in a case called Nabanco, which claimed that Visa's setting of interchange fees constituted unlawful horizontal price-fixing.

The court rejected the challenge to interchange on both per se and rule of reason analyses grounds. When the plaintiffs appealed, the appellate court also rejected the challenge to interchange and made it clear that interchange fees are a necessary part of the four-party system without which the system would not function. Plaintiffs appealed the appellate court's decision to the Supreme Court, which declined to hear the case.

More recently, in a case called Kendall, various merchants sued Visa, MasterCard and several banks, alleging that defendants had violated the antitrust laws by: (1) fixing merchant discounts directly; and (2) fixing default interchange fees, and thereby setting a "floor" for merchant discounts. The court dismissed the case on the pleadings, holding, as to MasterCard and Visa, that: (1) plaintiffs had not alleged facts showing a conspiracy to fix merchant discount fees directly; and (2) with respect to interchange, the acquiring banks, not the merchants, are the direct purchasers, and therefore the merchants lacked standing to sue. The court also held that "merely charging, adopting or following" the default interchange fees allegedly set by Visa and/or MasterCard did not constitute an antitrust violation by the bank defendants.[1]

In addition, beginning in June 2005, numerous merchants have filed suit in federal courts across the country against MasterCard, Visa, and, in some cases, a number of banks. In total, approximately 50 such cases have been filed. The Judicial Panel on Multidistrict Litigation has transferred these cases to the Eastern District of New York for coordinated pretrial proceedings in Multidistrict Litigation No. 1720. Plaintiffs filed a consolidated complaint in this matter. Defendants moved to dismiss or to strike certain claims and answered others. Two weeks ago, on July 5, 2006, plaintiffs filed a supplemental complaint challenging MasterCard's new ownership and governance structure under the antitrust laws. The trial lawyers have told the court that the supplemental complaint seeks to reverse and unwind MasterCard's IPO, which is an unprecedented form of relief in a private class action. In addition to the consolidated complaint, there are several individual merchant complaints. MasterCard moved to dismiss some claims brought in those individual complaints and answered others.

We also note an interesting inconsistency in these cases. The suits that the merchants have brought are based on a false premise that prices merchants pay for MasterCard and Visa are too high (as this is the alleged harm resulting from their claims). It is widely known, however, that American Express imposes merchant discounts that are on average the highest in the industry. Yet, the merchants have not brought suit challenging American Express' ability to set discount fees. The fact that merchants are willing to pay higher American Express fees without challenge suggests that merchants recognize they should pay for participating in the payment

[1] The Kendall decision is currently on appeal. A similar case, called Reyn's Pasta Bella, was brought by a group of small merchants in San Francisco. The case, which also attacked interchange as an unlawful price-fixing arrangement, was determined to be released by the settlement in the merchant class action brought by Wal-Mart and others.

systems. Merchant statements before Congress and in other public forums show that the issues they are raising about merchant discount really are a business dispute about price and not an antitrust or policy issue.

Fortunately, for merchants, consumers and all others who benefit from payment systems, it is a fundamental principle of antitrust law that the free market, not the government, should set prices. Any attempt to price regulate interchange fees at a reduced rate, which is their true objective, would be directly counter to this cornerstone element of our economic structure. Indeed, experience in Australia demonstrates that such an approach would only have one certain effect--consumers and competition would be harmed. The Reserve Bank of Australia (RBA) has effectuated price controls by regulating the interchange fee formula for the four-party systems in Australia. The net effect of the RBA's arbitrary price caps has been that consumers have seen annual fees and finance charges increase while consumer benefits have decreased. There is also no evidence that merchants have lowered prices to consumers as a result of their paying lower fees for card acceptance. (Importantly, the RBA actions were not based on any theory of antitrust law.)

Finally, many of the legal challenges MasterCard has faced in this area were directed at the traditional ownership and governance structure of the four-party system, in which the plaintiffs claim that the customer financial institutions that receive interchange improperly own the system and control the board of directors that set interchange. Although this structure was upheld in the Nabanco case and the merchants' allegations are without merit, MasterCard is now a publicly traded company with a majority of independent directors, and with the majority of voting power and equity in the hands of shareholders other than MasterCard's participating financial institutions. Showing their true intention of price regulations, rather than applauding this development that they had in essence been requesting for years (*i.e.*, an end to the alleged improper control of MasterCard by banks), the trial lawyers and special interest groups have instead expressed a desire for the unprecedented unwinding of the IPO. Such an action would, of course, restore the wholly-owned bank structure that these same trial lawyers and merchants have spoken against and sued over for years. Regardless, such a remedy is not only unprecedented, we believe it to be unwarranted.

It seems clear that the true objective of these efforts is government-mandated price caps on interchange fees that would be lower than the default rates established by MasterCard today. We cannot emphasize enough that there is no precedent for such a remedy under U.S. antitrust law, as such laws are in place to promote competition and to prevent price-fixing, not to arbitrarily set lower prices. Consumers would be harmed as a result of such action.

We are pleased to have the opportunity to brief this committee on the tremendous value of the MasterCard system with interchange. It is my pleasure to discuss this topic with you, and I would be pleased to answer any questions you may have.

1901 N. Fort Myer Drive • Suite 500 • Arlington, VA 22209-1604 • 703-351-8000 • Fax 703-351-9160

July 18, 2006

Chairman Arlen Specter
Ranking Member Patrick Leahy
United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Specter and Leahy:

On behalf of the Petroleum Marketers Association of America (PMAA) members, we thank you for holding the important hearing, "Credit Card Interchange Rates: Antitrust Concerns?" The issue of credit card interchange is one of the highest priorities of the members of PMAA. PMAA is a national federation of 45 state and regional trade associations who collectively represent over 8,000 petroleum marketing companies. These companies are independent small businesses and market a wide variety of products to include gasoline, diesel, heating oil, lubricants, jet fuel, kerosene and propane. Our members own over 60,000 gas station/ convenience stores and supply motor fuels to an additional 40,000 retail locations. PMAA also members market over 80% of the heating oil in the U.S.

As you are very much aware, the issue of gas prices is a very sensitive one to consumers. However, very few consumers know that they pay a hidden fee on virtually every gas station transaction they make, whether they use a credit card or not. For the typical gas station/convenience store operation, the cost of interchange and processing fees can be as high as three percent, a cost to consumers of an additional 9 cents per gallon with prices at $3 per gallon.

Our heating oil dealer members are struggling with interchange as well. Visa has classified heating oil dealer transactions to the mail order category, which is one of the highest interchange rates. PMAA recently inquired with Visa as to their rationale for charging their highest fees to heating oil dealers and consumers. There are over 42 million consumers in the United States that rely on heating oil or propane to heat their homes. All of these consumers' transactions are recurring and are low risk. Our members have strong relationships with their customers that span over many years, unlike a typical mail order retailer that shares this interchange classification. It does not make any sense that heating oil dealers should have their transactions classified as higher

risk. We believe that these types of transactions appropriately belong in the Utility Interchange category. However, Visa declined to shed any light on their rationale for these exorbitant fees.

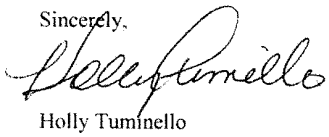
All retailers are grappling with rising interchange fees. Interchange costs consumers more than $26 billion annually. The end result is that Visa and MasterCard hit consumers in their pocketbooks by driving up the cost of good and services regardless of whether consumers pay with plastic, cash or check.

It is time to force credit card companies to explain their fees, practices and policies in public. While Visa will say its fees are transparent, this is far from the truth. However, Visa announced just a few days ago in anticipation of your hearing – is that it will make its operating rules available to merchants beginning September 1. But this is nothing more than an attempt to distract you from the issue. To see these operating rules, that Visa and MasterCard have long contended are already available, merchants must first sign an agreement to abide by the rules that they have not yet seen. Further, they may only view these rules online and may not obtain a print copy. In addition, they must sign a non-disclosure agreement prohibiting them from discussing these rules with anyone, including Members of your Committee.

Visa and MasterCard control a system that is fundamentally anti-competitive and they want to keep it that way. Visa member banks collectively agree to charge the same interchange rates; MasterCard member banks do, too. This price-fixing hurts consumers and must stop. I thank you for scheduling this hearing to closely examine these fees and demand answers from the credit card companies.

Thank you for your attention to this issue.

Sincerely,



Holly Tuminello
Vice President