2 April 2015

Mr David Crawford
Senior Adviser, Financial System and Services Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Mr Crawford,

Financial System Inquiry Final Report

Qantas welcomes the opportunity to comment on the Financial System Inquiry Final Report (the Report) released on Sunday, 7 December 2014.

As well as being a large merchant, Qantas is also a key participant in the issuing side of card payments – both through Qantas Cash and the issuance of Qantas Frequent Flyer points – providing us a broad perspective on the impact of changes to the payments system. Whilst Qantas supports efforts to deliver efficiency and economic reform in the public interest, we believe that both the basis and potential unintended impacts of recommendations in the Report require further very careful consideration in any plans for additional regulatory reform.

The following are our comments which relate to the Interchange fees and customer surcharging section (page 168 of the Report):

1. Qantas does not believe there is any need for further regulatory intervention

The Payment Systems Board (PSB) has conducted extensive and robust reviews into and reforms of interchange fees and customer surcharging over the last 15 years, including:

- Initial Joint Study evaluating interchange fees and access (2000);
- Credit Card Reforms (2002-04);
- Debit Card Reforms (2004-06);
- Review of the Card Payment System Reforms (2007-08);
- Strategic Review of Innovations in the Payments System (2011-13);
- Variation to the Surcharging Standards (2012-13); and
- The Evolution of Payment Costs in Australia Research Paper (2014).

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The reforms have met the key PSB objectives, including reducing the overall resource costs of the payments system and allowing price signalling, through surcharging, to direct consumer payment choice. Given these trends appear likely to continue under the current regulatory framework, Qantas believes further intervention is not warranted.

2. Qantas believes that the recommendations in the Report are:

i) Based on flawed assumptions:

a) Offshore experience not relevant

The Report referenced offshore regulatory developments in interchange and surcharging as one of its bases for further intervention. Qantas believes it is a high risk to rely on changes in offshore jurisdictions as justification for increased regulation, given that:

- Offshore reforms are either still pending implementation (or have been implemented very recently) meaning that the understanding of their impacts on consumers, merchants and the broader economy is very limited; and
- There is no analysis of their appropriateness for the Australian system.

b) Incorrect assumption that interchange fees fund rewards programs

The interchange benchmark calculation includes the following cost items from the card issuer:

- Cost of processing the payment transaction;
- Cost of fraud and bad debts; and
- Cost of funding the interest free period.

These cost categories were identified through extensive analysis of payment card economics at the time and do not include any component for funding consumer incentives such as reward programs. As such, interchange fees, by definition, do not cross-subsidise loyalty costs borne by the issuer.

This incorrect assumption has distorted the debate. Given that there is no provision for recovery of reward costs in interchange fees, lowering them further to reduce the potential for cross-subsidisation has no basis.

c) Lowering current interchange cap has no basis

The Report's recommendation to simply lower the current interchange cap has no basis. Along with the fact that interchange fees do not fund rewards programs, the Report has not provided a clear methodology by which the cap would be lowered, and the current benchmark cap has not been recently updated. Therefore, lowering the interchange cap without further analysis is unsuitable.

Qantas believes it is more appropriate to update the benchmark to reflect current costs and increase the frequency of benchmark assessment to ensure the interchange benchmark remains in line with current and ongoing market dynamics under the existing regulatory framework.

d) Incorrect assumptions about excessive surcharging

The Report has not demonstrated an understanding of the *actual total cost of card acceptance*, including the merchant service fee (MSF).

Qantas believes that capping surcharges to a market average MSF is flawed, given that MSFs vary significantly between merchants, and that merchants' total cost of card acceptance includes a range of fixed costs in addition to the MSF, which also vary by merchant. For instance, the overall cost to Qantas of accepting cards is higher than average due to:

- Mix of customers and their payment choice;
- Investment in technology, equipment and services for payment processing;
- The cost of establishing necessary infrastructure;
- Costs payable to other parties, such as gateway or switching fees, fraud and fraud prevention costs; and
- Other security and compliance costs.

Qantas' current card payment fees are in line with the current Surcharging Standards and significantly under-recover the total cost of card acceptance. Moreover, Qantas' surcharges distinguish between low and high cost payment types (debit and credit); are transparent and disclosed to customers well in advance of purchase; and can be avoided using increasingly popular and accessible fee-free payment options in all selling channels.

e) The Report's examples on surcharging are clearly misleading

Compounding confusion in the public debate on surcharging, the Report's examples provided in Box 10 (page 170) misrepresent the current situation with regard to airline fees. Under the Australian Consumer Law, merchants must either include their surcharges in the advertised price or provide a fee-free payment option. Any fees must be adequately disclosed to consumers.

As in the case of Qantas, consumers have the choice to pay with fee-free options or use a form of payment that incurs a fee, which they may be for reasons of convenience or to take advantage of other benefits.

ii) Add undue regulatory burden and complexity

Implementation of these recommendations would increase the regulatory burden, and add undue complexity and cost to the payments system where sound, market-based mechanisms already exist. Further, the continued inconsistency in regulating some schemes or products and not others exacerbates this complexity.

Specifically, a three-tier surcharging system would be significantly more complex and costly. The proposal would require merchants to:

- Identify which cards fall into each of the three different card categories;
- Calculate different fee levels for medium and high cost categories;

- Develop, implement and fund technical solutions to process the three categories; and
- Communicate the complex fee regime in a manner that puts consumers on notice of the amount (if any) that will apply to their card transaction type.

Enforcement would not be easier, given the proposed mechanism remains exactly the same except that merchant compliance with three different regimes would be more complex to assess.

The Inquiry has failed to demonstrate how these outcomes would make the surcharging arrangements more effective.

iii) Unlikely to result in consumer benefits

The Report has failed to demonstrate a clear link between its recommendations and net consumer benefits. In relation to interchange fees, there is no basis for assuming that a reduction in fees will result in a reduction to consumer end-pricing.

The proposed regulatory reduction of interchange fees will result in issuer under-recovery of actual interchange costs, based on the current established determination of those costs. Issuers are unlikely to merely absorb this reduction in revenue, but rather compensate for it by other means. These are likely to be ultimately passed on to merchants and consumers through higher annual fees and interest rates, as well as the possible reduction of reward programs and cardholder benefits (as has been seen in the past).

In relation to surcharging, the additional complexity of a three-tier system may result in unintended consequences with adverse impacts on consumers (discussed below).

iv) Likely to cause have unintended consequences requiring further consideration

a) Broader economic impacts

In the event that issuers choose to reduce cardholder rewards programs to compensate inability to recover the costs of interchange, this is likely to have a disruptive effect on consumers, businesses and the broader economy.

Cardholder rewards programs have a stimulatory effect on consumer spending, particularly in tourism and related industries. Therefore, a reduction in reward programs is likely to result in unintended downstream impacts on these key industries, which are critical to the broader economy.

Impacts on rewards programs are also likely to have flow-on effects on program partners. For example, Qantas has multiple program partners across a range of key industries that are likely to be impacted.

b) Surcharging complexity may defeat the Report's objective

The requirement for merchants to implement an excessively complex three-tiered surcharge structure means clear disclosure to customers will be difficult to achieve. The onerous nature of its implementation may mean it is impracticable, which may put at risk the merchants' ability or willingness to effectively price-signal to consumers. This outcome would defeat the very purpose of the regulation and be a backward regulatory step with no clear benefit.

Qantas believes the existing regulatory framework should be leveraged to ensure benchmarks and standards are in line with current market dynamics, as a first step prior to introducing further regulation. Qantas is asking the Government to consider carefully both the basis for any proposed changes, and their potential consequences in its review of the Report's recommendations.

Qantas recommends that the Government leverages the existing, robust regulatory framework to achieve its stated objectives.

We would welcome the opportunity to expand on any of the above points.

Yours sincerely,

Andrew Parker
Group Executive, Government and International Affairs