BIS Department for Business Innovation & Skills

CONSULTATION ON THE EARLY IMPLEMENTATION OF A BAN ON ABOVE COST PAYMENT SURCHARGES

Impact assessment

SEPTEMBER 2012

CONTENTS

Title: Consultation on the early implementation of a ban on above cost payment surcharges: impact assessment	Impact Assessment (IA)
IA No: BIS 0380	**Date:** 30/07/2012
Lead department or agency: Department of Business, Innovation and Skills	**Stage:** Development/Options
Other departments or agencies: HM Treasury	**Source of intervention:** Domestic
	Type of measure: Secondary legislation
	Contact for enquiries: Hannah Donaghey. BIS 020 7215 6394

Summary: Intervention and Options

RPC Opinion: Awaiting Scrutiny

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£0m	£0m	£0m	Yes	Zero Net Cost

What is the problem under consideration? Why is government intervention necessary?

A payment surcharge is an additional fee payable by the buyer to the seller for using a particular form of payment, such as a debit or credit card. The OFT has concluded in a report on the effects of card surcharges, that the level of surcharges exceed the real costs in several sectors of the economy. These surcharges are typically employed as a form of drip pricing, whereby the consumer does not see the final transaction price until after completing several forms. This is to the detriment of consumers as they cannot effectively compare prices to secure the best deals. The dilution of price transparency weakens competition and will therefore tend over time to inhibit innovation and growth.

What are the policy objectives and the intended effects?

To promote competition and consumer welfare through greater price transparency:

- Consumers will be able to compare prices more easily leading to improved competitive conditions.
- Payment surcharges may become cost-reflective, steering consumers to the most efficient payment method in light of greater competition.
- The level of surcharges may fall or in some cases disappear altogether, where they currently exceed the costs of collecting a payment.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 1: The Consumer Rights Directive will prohibit above-cost surcharges in most retail sectors for all types of payment method by the Directive's June 2014 deadline.

Option 2: Implement the Consumer Rights Directive ban (as in Option 1) in 2013. This is the preferred option.

Option 3: Implement an alternative recommendation to ban debit card surcharges completely.

Option 4: Implement a ban on surcharges altogether for all types of payment method across all economic sectors.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 06/2014

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** n/a	**Non-traded:** n/a	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Date: 31/08/2012

Summary: Analysis & Evidence — Policy Option 1

Description: Implement the CRD above-cost surcharges ban in most retail sectors on all types of payment methods on the Directive's June 2014 deadline.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate: 0**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		0	**0**

Description and scale of key monetised costs by 'main affected groups'

n/a

Other key non-monetised costs by 'main affected groups'

This option is expected to impose negligible costs on business. This is because (i) a transition period of up to 12 months would give merchants adequate time to factor pricing changes into their routine price updates, systems upgrades and maintenance and (ii) any costs in factoring in these pricing changes into their regular price updates would be negligible. There is expected to be a small increase in regulatory costs. There would be no direct or indirect costs on the card networks, acquirers or payment service providers or intermediaries or consumers.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	n/a		n/a	**n/a**

Description and scale of key monetised benefits by 'main affected groups'

The benefits cannot be directly quantified, and are mostly qualitative. One useful quantitative proxy to indicate the gross value of surcharges that consumers will be made more aware of is the level of credit and debit card surcharges, which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential qualitative (non-cash) benefits to consumers through increased transparency.

Other key non-monetised benefits by 'main affected groups'

• Consumers will be able to compare prices more easily, boosting competition in areas where surcharges are common.
• Payment surcharges may become more cost-reflective, steering consumers to the most efficient payment method in light of greater conmeptition.
• The level of surcharges may fall or in some cases disappear altogether, where they currently exceed the costs of collecting a payment.

Key assumptions/sensitivities/risks — **Discount rate (%)** n/a

Consumers are not expected to make any significant cash savings following the implementation of this proposal as merchants are likely to compensate lost revenue with either a rise in headline prices or alternative additional charges (or a combination of the two), however with greater transparency in pricing and consequently greater competition, consumers will be able to make more informed decisions. The behavioural changes following a rise in headline price are unknown, as although headline prices may rise (lost revenue may be recovered in other additional charges), the overall price is expected to be unchanged. It is likely that businesses anticipate any rise in headline prices to lead to a fall in demand, and so would increase additional charges instead. With greater transparency however these charges will not be hidden. In addition greater transparency reduces the search costs for consumers and may lead to a positive behavioural change for demand, however this is not quantified.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	**Benefits:** n/a	**Net:** n/a	No	Zero net cost

Summary: Analysis & Evidence **Policy Option 2**

Description: Implement the Consumer Rights Directive ban on above-cost payment surcharges on all types of payment methods in 2013.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** 0

COSTS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		0	**0**

Description and scale of key monetised costs by 'main affected groups'

n/a

Other key non-monetised costs by 'main affected groups'

This option is expected to impose negligible costs on business. There is no expected reduction in revenues, merely a change in price calculation and display. This cost is negligible, when undertaken with a lengthy transition period and factored in concurrently with other routine price updates, systems upgrades and maintenance. There is expected to be a small increase in regulatory costs. There would be no direct or indirect costs on the card networks, acquirers or payment service providers or intermediaries or consumers.

BENEFITS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	n/a		n/a	**n/a**

Description and scale of key monetised benefits by 'main affected groups'

The benefits cannot be directly quantified and are mostly qualitative. One useful quantitative proxy to indicate the gross value of surcharges that consumers will be made more aware of is the level of credit and debit card surcharges which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential quantitative (non-cash) benefits to consumers through increased transparency.

Other key non-monetised benefits by 'main affected groups'

Consumers will be less misled by payment surcharges that are separate from the headline prices. The surcharges will reflect the cost incurred by the merchants only. Surcharges may decrease significantly in some sectors where businesses apply surcharges that are significantly above the costs bourne, such as the merchant service fee. Cost-related surcharges will also enable customers to see the relative price of specific payment methods which could lead merchants to negotiate lower merchant services fees with the acquirers.

Key assumptions/sensitivities/risks **Discount rate (%)** n/a

Consumers are not expected to make any significant cash savings following the implementation of this proposal as merchants are likely to compensate lost revenue with either a rise in headline prices or alternative additional charges (or a combination of the two), however with greater transparency in pricing and consequently greater competition, consumers will be able to make more informed decisions. The behavioural changes following a rise in headline price are unknown, as although headline prices may rise (lost revenue may be recovered in other additional charges), the overall price is expected to be unchanged. It is likely that businesses anticipate any rise in headline prices to lead to a fall in demand, and so would increase additional charges instead. With greater transparency however these charges will not be hidden. In addition greater transparency reduces the search costs for consumers and may lead to a positive behavioural change for demand, however this is not quantified.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	**Benefits:** n/a	**Net:** n/a	No	Zero net cost

Summary: Analysis & Evidence — Policy Option 3

Description: Implement an alternative recommendation to ban debit card surcharges in full in 2013 but repeal in June 2014 when CRD provision must take effect

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate: 0**

COSTS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	n/a		n/a	**n/a**

Description and scale of key monetised costs by 'main affected groups'

The costs cannot be directly quantified. One useful quantitative proxy is the level of debit card surcharges which were worth between £166 million and £230 million in 2010. This could be taken to represent the upper ceiling of the value of potential quantitative (non-cash) costs to merchants.

Other key non-monetised costs by 'main affected groups'

Implementing a ban on debit card surcharges alone is likely to distort the card market and may produce a change in behaviour. Consumers moving from other payment methods to that of debit cards may incur a higher cost to merchants in further lost revenue from surcharges that were not cost-reflective. This cost cannot be directly quantified.

BENEFITS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	n/a		n/a	**n/a**

Description and scale of key monetised benefits by 'main affected groups'

The benefits cannot be directly quantified. One useful quantitative proxy is the level of debit card surcharges which were worth between £166 million and £230 million in 2010. The level of surcharges that were cost reflective was between £88-£122 million in 2010, implying a potential benefit of £78-£108 million for debit cardholders alone.

Other key non-monetised benefits by 'main affected groups'

Consumers will have at least one 'free' method of payment. They will no longer be misled by unavoidable payment surcharges that are separate from the headline prices, enabling them to compare prices and shop around more easily. Better price comparability will enhance competition.

Key assumptions/sensitivities/risks — **Discount rate (%)** n/a

This provision would need to be repealed in June 2014 and replaced with the CRD ban on above cost surcharges to meet obligations under that Directive.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs: n/a	**Benefits:** n/a	**Net:** n/a	No	Zero net cost

Summary: Analysis & Evidence — Policy Option 4

Description: Ban payment surcharges altogether on all types of cards and other payment methods across all economic sectors (in 2013). To be repealed and replaced by CRD provision in June 2014.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** 0

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		316	**316**
High	Optional		630	**630**
Best Estimate	0		473	**473**

Description and scale of key monetised costs by 'main affected groups'

The costs cannot be directly quantified. One useful quantitative proxy is the level of credit and debit card surcharges which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential quantitative (non-cash) costs to merchants.

Other key non-monetised costs by 'main affected groups'

n/a

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		316	**316**
High	Optional		630	**630**
Best Estimate	n/a		473	**473**

Description and scale of key monetised benefits by 'main affected groups'

The benefits cannot be directly quantified. One useful quantitative proxy is the level of credit and debit card surcharges which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential quantitative (non-cash) benefits to consumers.

Other key non-monetised benefits by 'main affected groups'

Consumers will no longer be misled by unavoidable payment surcharges that are separate from the headline prices. Consumers will be able to compare prices and shop around more easily. The prices will be easier to understand as there won't be any differences according to the payment method chosen. Merchants will save on implementation costs as they will no longer need to specify when consumers will pay a surcharge for a particular type of payment. In banning surcharges this produces a transfer from merchants to consumers.

Key assumptions/sensitivities/risks — **Discount rate (%)** n/a

Ban would need to be repealed and replaced by CRD ban on above cost payment surcharges in June 2014 to meet CRD requirements.

BUSINESS ASSESSMENT (Option 4)

Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs: 473	**Benefits:** n/a	**Net:** n/a	No	Zero net cost

Evidence Base (for summary sheets)

What is the problem under consideration?

In March 2011 the Office of Fair Trading (OFT) received a super-complaint from Which? (a designated consumer body under the Enterprise Act 2002) relating to surcharges that are imposed by transport companies on passengers for paying by debit or credit cards. The super-complaint addressed the lack of transparency of such surcharges, and the excessive level of surcharges, which exceed the real costs incurred by retailers in accepting payment by debit or credit cards.

The OFT published its response to the super-complaint in June 2011. It provided evidence that excessive payment surcharges are widespread in the passenger transport sector and concluded that this practice is likely to result in consumer detriment. The OFT recommended that the Government should introduce measures to prohibit retailers from surcharging altogether on payments made by debit cards only to ensure a meaningful and consistent solution across the economy.

In December 2011 the Government announced that it would take action to tackle excessive surcharges on all payment methods, not just debit cards, in most sectors of the economy. The Government further announced that it would consult on the early implementation of a provision of the EU Consumer Rights Directive (CRD) with the goal of banning above-cost payment surcharges by the end of 2012. The CRD bans above-cost surcharges on any payment method and is to be implemented by June 2014.

It is important to stress that the proposed action on payment surcharges forms part of a package of measures that are being coordinated with action being taken by the Office of Fair Trading (OFT) to ensure that all transaction charges in the passenger transport sector, where surcharges are causing detriment, are made clear to customers at the beginning, not the end, of a transaction. The OFT will consider extending this initiative to other sectors as may be necessary. The purpose of these measures is to ensure that customers can compare prices fairly. This will increase competition by preventing the increasingly opaque pricing practices being adopted by some on-line merchants. This includes drip pricing, where consumers are only revealed the final price after expending time and effort to complete several forms, which means that they become reluctant to undertake further price comparisons, requiring more time and effort.

The purpose of this measure is not therefore to directly force merchants to lower headline prices, since overall prices are expected to remain broadly unchanged. The purpose is to ensure that prices and optional extras are quoted on a reasonably comparable basis. Competitive conditions are likely to improve, as the ability for consumers to compare offers improves.

There is already some evidence that merchants are changing their practices in anticipation of legislation, for example, some airlines have begun to offer surcharge free debit card purchases.

Methodology

In preparing this impact assessment officials have discussed the proposals with the OFT, Visa and MasterCard, a major on-line merchant that applies above-cost debit and credit card surcharges, the British Retailers Consortium, the UK Cards Association, selected banks and a specialist management consultancy which provides advice to on-line merchants, including major airlines, and has undertaken research on the impacts of card surcharges in other countries.

Officials sought advice on the cost structures underpinning card surcharges, the admin costs of making pricing changes to IT systems and web sites, and on any potential knock-on consequences. The OFT and HM Treasury have undertaken work to assess the extent and level of surcharging in the UK.

Payment Surcharge

A payment surcharge is an additional fee payable by the buyer (client, customer; hereinafter “customer”) to the seller or seller’s representative (trader, firm, merchant; hereinafter “merchant”) for using a particular form of payment, such as a debit card.

A payment surcharge can take the form of a fixed fee per transaction; a percentage of the transaction value; or a fee per item purchased. For example, a payment surcharge on a single purchase of ten items costing £1 each (£10 in total) may appear as:

£10 transaction value + 1% surcharge = £10.10
£10 transaction value + £1 surcharge per transaction = £11
£10 transaction value + £1 surcharge per item = £20

Fees payable by a merchant (such as card processing fees) to the payment service provider (or 'acquirer') for on-line payments are not payment surcharges, because they are levied by the acquirer, not the merchant, in return for payment services provided to the merchant.

Estimated total value of card payment surcharges in the UK in 2010 (millions)		
Debit Cards	Credit cards	Total
£198	£275	£473

HM Treasury estimates, 2011

Discounts

Some merchants (typically utility companies) offer discounts for paying bills regularly by direct debit. It is not proposed to ban this practice. Merchants generate efficiency gains and cost savings by collecting regular payments by direct debit, which may be passed onto customers. Discounts do not seem to apply to other forms of payment in the UK at present.

Affected sectors

Overall: There are fewer payment surcharges on consumers paying with cash, cheque or credit transfer in the UK. Evidence suggests that very few merchants and some utility companies may impose a surcharge for accepting a cheque. The most common application here is by utility companies who increasingly apply a charge (of around £4-5 a quarter) for payments by cash or cheque. Payment surcharges appear to be limited to payments by plastic (payment) card, most commonly on-line. In 2007, the OFT found[1] that 19% of businesses that accepted card payments surcharged at least one card type (14% to credit cards, 9% to charge cards, and 6% to debit cards). 81 per cent of businesses applied no payment surcharges at all. A quarter of businesses that surcharged did so only on transactions below a certain level.

Retailers largely do not apply payment surcharges at the point of sale. The EDC survey[2] indicated that almost no retailer applied a surcharge to over-the-counter cardholder-present transaction (i.e., surcharging in store was very rare).

There are two main reasons why retailers do not tend to surcharge over-the-counter transactions: (i) competition within the retail sector puts any retailer that imposes a payment surcharge at a competitive disadvantage; and (ii), it is difficult for retailers to distinguish card types at the point of sale in store. According to the British Retail Consortium, there are currently over 270 different card types in the UK. Complex hardware, software and staff training would be required to implement an accurate surcharging mechanism and process at the point of sale[3].

Small businesses largely do not apply payment surcharges, for the same reasons as larger retailers. However, some small businesses like corner shops, pubs and off licenses apply a payment card surcharge, particularly for low value transactions (typically under £10) or do not accept card payments for less than this value. Options 2 to 4 assume that SMEs will be exempted from a surcharging ban until June 2014 as part of the Government's moratorium on new regulation for SMEs[4]. From June 2014 the Government will be required to give full effect to the Consumer Rights Directive and will be obliged to apply the ban to all businesses operating within the scope of the Directive. Options 1 and 2 will enable

[1] 2007 OFT survey of 1,052 businesses across the UK that accept card payments, including retailers, wholesalers and public sector bodies.
[2] 2010 Potential Introduction of Surcharging in France: Impact Study by Edgar, Dunn & Company
[3] 2011 OFT Payment surcharges - Response to the Which? super-complaint
[4] The Government's *Plan for Growth* published alongside the Budget in March 2011 introduced a number of policy measures supporting SMEs. These included a moratorium exempting SMEs from new domestic regulation for three years from 1 April 2011.

small businesses to continue to recover the reasonable direct costs they incur in accepting card payments.

Service sector: payment surcharges are common in the airline sector, and less frequent in other sectors, notably rail, ferries, taxis, event tickets, cinemas, car dealerships, holidays, hotels and parking. As in the retail sector, payment surcharges seem to apply most commonly to on-line and telephone transactions (card-not-present transactions), rather than face to face. Payment cards are often the only payment method offered by merchants for on-line transactions in the UK.

Business to business: payment surcharges are not common practice.

Third sector: payment surcharges are not common practice.

Central and Local Government: Some Government agencies and local councils have begun to impose credit card surcharges to recover the costs they incur on accepting credit card payments, for example for paying council tax, business rates or planning application fees, or buying a tax disc from the DVLA, or making some tax payments to HMRC.

The following table shows the estimated range of payment surcharges in the principal affected sectors:

Estimated total value of card surcharges in the principal affected sectors in 2010			
	Lower estimate	**Upper estimate**	**Midpoint**
Airlines	£223,300,000	£354,600,000	£289,000,000
Ferries	£27,400,000	£145,200,000	£86,300,000
Rail	£32,900,000	£65,700,000	£49,300,000
Leisure	£32,500,000	£64,900,000	£48,700,000
Total	£316,000,000	£630,400,000	£473,200,000
HM Treasury estimates based on market research, 2011			

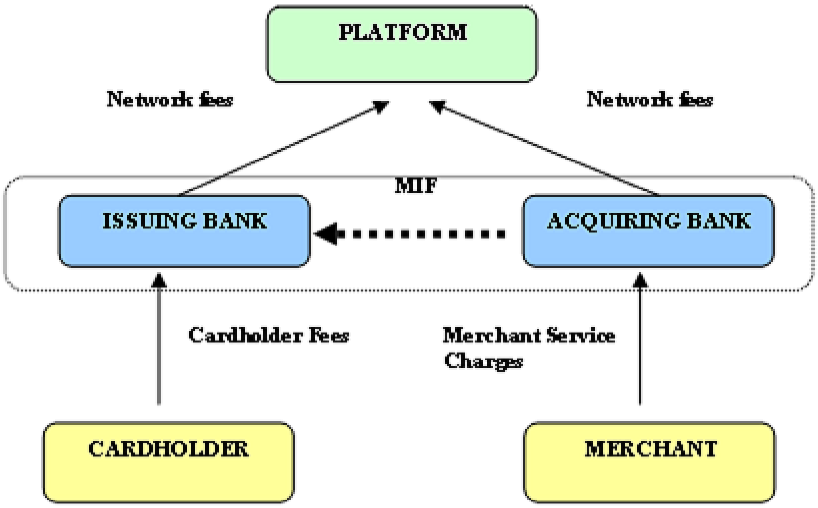
Totals by card type			
	Debit cards	**Credit cards**	**Total**
Airlines	£152,000,000	£136,900,000	£289,000,000
Ferries	£25,300,000	£61,000,000	£86,300,000
Rail	£12,600,000	£36,700,000	£49,300,000
Leisure	£8,000,000	£40,700,000	£48,700,000
Total	£198,000,000	£275,200,000	£473,200,000
HM Treasury estimates based on market research, 2011			

Costs of taking payment by debit or credit card

Fees payable in the four party model

In a four party model, the customer (cardholder) buys goods or services from the seller (merchant) and pays by payment card. The cardholder's bank which issued his/her payment card, is called the issuing bank (or issuer). The acquirers (acquiring banks) are mostly banks that sign merchants up to the card networks like Visa and MasterCard and process payments The platform represents VISA or MasterCard or other independent transaction processing, clearing and settlement services.

The fee structure is complex. In general, there are fees (such as the merchant service fee) payable by merchants in favour of the issuers. In a four party model, there is a multilateral interchange fee (MIF) payable by the acquirer to the issuer. Other fees are payable by both the acquirer and the issuer. The cardholder may be charged by his/her bank (issuer) as well. For example, additional fees apply to regional or global transactions.



Cost of card acceptance

There are several types of cost borne by the merchant when accepting a card payment. These include[5]:

1. **Merchant service charge** – represents 80 - 85% of the costs and can be either a bundled rate (as % of the transaction value), or a flat rate per transaction,
2. **IT infrastructure** – represents 8 - 12% of the costs and includes Point Of Sale (POS) devices, website, telecommunications, payment services provider for e-commerce transactions. Equipment (which may be leased, rented or purchased) is often integrated with other accounting systems;
3. **Delayed Receipt of Funds** – represents 2 - 5% of the costs and are a consequence of banks (acquirers) delaying settlement with the merchant,
4. **Risk management** – represents 1 - 2% of the costs and include various risk and fraud prevention mechanisms, and compliance with industry security standards,
5. **Fraud losses** and charge backs– represents up to 3% of the costs and mostly affect on-line merchants,
6. **Operations** – represents up to 3% of the costs and include staff training, chargeback processing (returning funds to a consumer when a transaction is reversed), exception handling and reconciliation.

For considering the impacts of Options 3 and 4, it is useful to categorise the above costs as external and internal to the merchant.

External costs: form the main costs to merchants. These are fees paid to acquirers, and/or intermediaries who provide equipment, fraud detection and processing services (especially for online payments). For some merchants, these external costs are the only costs of accepting card payments. They typically take the form of: a standing charge, service charges for processing transactions; fees for charge-backs; and fees for point of sale (POS) terminals. However, debit cards, credit cards, charge cards and prepaid cards all have different specific fee structures.

Some merchants pay for an all inclusive service where an intermediary handles all aspects of online payments through its website. Small retailers (a few hundred payments per month) can pay a fixed monthly fee and avoid dealing with acquirers directly or paying any per-transaction fees. Larger retailers usually pay confidential negotiated rates for anything from fraud management up to full web hosting and transaction processing services.

Internal costs: The costs of taking card payment are mainly leasing or buying and maintaining terminals (printers or EFT POS machines); fraud monitoring; complying with data security standards; infrastructure like websites or call centres; and staff training. However, these costs may not be separable from general overheads of staying in business. For example, there may be no significant marginal cost in adding payment functionality to a website, which is necessary for being in business on-line.

[5] Edgar, Dunn & Company - structure and indicative proportion of the overall cost of acceptance

Many businesses outsource payment services to intermediaries and face no direct internal costs of their own. Those that do incur direct costs, for example relating to website development and management time, suggest they form part of general overheads or one-off investments rather than ongoing direct costs. But it is not possible to refine this down to the level of per-transaction costs for particular categories of business without access to sensitive commercial data that merchants are unwilling to share.

Illustrative costs

The OFT's report included a table showing travel providers' average costs. Further research suggests that these costs are fairly typical across other sectors.

Illustrative costs of processing card transactions (travel providers)								
Transaction size, corresponding merchant service cost (as % of the transaction size)								
Card type	£50		£100		£250		£500	
Credit card	£1.16	(2.3%)	£2.10	(2.1%)	£4.94	(2.0%)	£9.66	(1.9%)
Charge card	£1.52	(3.0%)	£2.84	(2.8%)	£6.77	(2.0%)	£13.34	(2.7%)
Debit card	£0.53	(1.1%)	£0.53	(0.5%)	£0.53	(0.2%)	£0.53	(0.1%)
OFT Payment surcharges - Response to the Which? super-complaint, 2011								

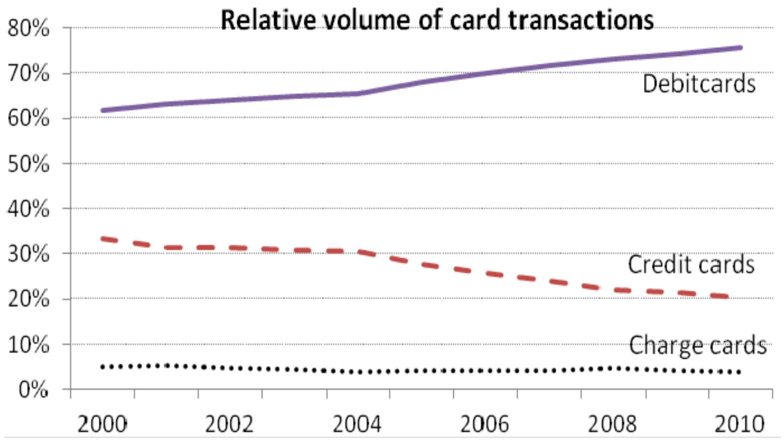
Volume and value of card transactions

The volume and value of card transactions in 2010 was

UK Card Transactions in 2010				
	Number (m)	%	Value (£m)	%
Credit cards	1,709	20.3	101,025	23.6
Charge cards	330	3.9	35,250	8.2
Debit cards	6,386	75.8	291,644	68.2
Total	8,425	100	427,919	100
Payments Council annual statistics. 2010. Tables 6.2 and 6.3				

The volume and value of credit card transactions continues to rise every year, but is rising more slowly than the volume and value of debit card transactions. A number of factors are thought to be contributing to the relatively faster growth of debit card transactions, for example there are more debit cards in issue than credit cards[6], and many customers do not need, or are ineligible for, credit, but the factors driving the trend also include the spread of credit card surcharges. The following chart illustrates the percentage of the total volume of transactions taken by debit, credit and charge cards.

[6] 84,642 debit cards compared to 55,601 credit cards in 2010. Payments Council annual statistics. 2010



Forecasts: 2010 - 2020

UK Card forecasts			
	Billion	**2010**	**2020**
Credit card	Volume	2.0	2.9
Debit card	Volume	6.4	12.8
Credit card	Value	£101	£194
Debit card	Value	£292	£600
Payments Council: UK payment markets. 2010.			

Option 1:

Implement the CRD above-cost surcharges ban in most retail sectors on all types of payment methods on the Directive's June 2014 deadline.

The costs and benefits of Option 1 correspond with the costs and benefits of Option 2, with the following exceptions:

1. SMEs and start-ups would have to comply with the ban on above-cost surcharges at the same time as large enterprises. There will be no competition advantage for microenterprises compared to Option 2.

2. All merchants would benefit from a longer implementation period (until June 2014) compared to Option 2 (until 2013).

Option 2: (the preferred option)

Implement the Consumer Rights Directive ban on above-cost payment surcharges on all types of payment methods in 2013.

Summary

This option is not freestanding. It forms part of a package of measures that are being coordinated with action being taken by the Office of Fair Trading (OFT) to ensure that all transaction charges in the passenger transport sector, where surcharges are causing detriment, are made clear to customers at the beginning, not the end, of a transaction. The OFT will consider extending this initiative to other sectors as may be necessary. The purpose of these measures is to ensure compliance with the Consumer Protection from Unfair Trading Regulations (2008) to ensure that customers can compare prices fairly. This will increase competition by preventing the increasingly opaque pricing practices being adopted by some on-line merchants.

The purpose of this measure is not therefore to force merchants to lower their prices, but to ensure that prices and optional extras are quoted on a reasonably comparable basis. There is expected to be no transfer or pass-through of revenue from businesses to consumers. Businesses will either increase their headline prices to offset a reduction in revenues from surcharges, or they may introduce an alternative (more transparent) charge structure. Some companies operating in the airline sector, where card surcharges are commonplace, have already started shifting the way prices are presented to consumers.

It is expected that the direct administrative one-off costs of a ban on above-cost payment surcharges would be borne by the merchants that currently impose above-cost payment surcharges and those that would need to analyse whether their current levels of surcharging are truly cost-reflective. There would be no direct costs on the card networks, on acquirers or payment service providers or intermediaries or consumers.

Costs: This option is expected to impose no additional costs on business. This is because:

(i) Micro-enterprises will be exempt until June 2014;

(ii) Merchants recalculate and adjust prices frequently (some airlines adjust prices in real time). A change in one price factor in the multi-factor pricing calculation is virtually costless;

(iii) a transition period of up to 6 months will give merchants more than enough time to factor pricing changes into their routine price updates, systems upgrades and maintenance;

(iv) For the same reason, consequential changes to web pages are also virtually costless. This is because web pages are under continuous development. The marginal cost of removing or updating the surcharge price displayed is a negligible simplification and cannot be disentangled from other regular changes and updates (bearing in mind that merchants will be required to display all their charges transparently and will also need to make changes to reflect this under existing legislation).

(v) There are no consequential impacts on back-end systems or administration.

There is expected to be a small increase in regulatory costs.

There would be no direct costs on the card networks, on acquirers or payment service providers or intermediaries or consumers.

Benefits: As this is part of a package of measures to improve on-line price transparency, consumers will be able to compare prices and shop around more easily. Better price comparability will enhance competition.

Cost-related surcharges will steer customers to the more economically efficient payment methods.

The benefits cannot be directly quantified, and are mostly qualitative. One useful quantitative proxy to indicate the gross value of surcharges that consumers will be made more aware of is the level of credit and debit card surcharges, which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential qualitative (non-cash) benefits to consumers through increased transparency.

Assumptions

- **Micro-enterprises/start-ups exempted:** It is assumed that in general, a total payment surcharge ban will apply to all commercial sectors. The moratorium on new regulation for micro-businesses and start-ups will apply until June 2014.
- **Business to business and third sector:** Business to business transactions are outside scope. Debit and credit card fees are not applied in these sectors to any significant degree.
- **Central and local government:** It is assumed that central and local government will be exempt, except for those local government services that are provided on a contractual basis (such as local sports facilities).
- **Other sectors:** The majority of retailers do not apply payment surcharges in face-to-face transactions. Payment surcharges apply predominantly to on-line and telephone transactions. Payment surcharges for credit cards as well as debit cards are applied mainly in the transport sector, particularly by airlines, ferry companies, travel agents, and ticketing agencies. However, some other businesses apply payment card charges, such as cinemas, theatres and concert venues, sports events, budget hotels, holiday bookings, car parks and a few estate agents and car rental merchants.

The Consumer Rights Directive

The Consumer Rights Directive (Article 19) provides that “Member States shall prohibit traders from charging consumers, in respect of the use of a given means of payment, fees that exceed the cost borne by the trader for the use of such means.” (above-cost payment surcharges for short).

The CRD excludes a number of market sectors from scope. It is assumed that these sectors will be exempt from the UK implementing legislation. However, the Government believes it may be necessary to extend the scope to include package travel contracts which are exempt from the CRD. The Government will consult on this. It would count as gold-plating the Directive, but is justified by the need to place package travel on an equal footing with standalone transport. Central and local government, and the voluntary sector will be exempt, except where they provide goods or services to consumers under contact (such as local authority sports facilities).

Costs of using a payment card

As described in the background section, there are different types of cost payable by all parties. In Option 2, the surcharge ban applies to additional charges added to the headline price which are paid by customers to the merchants for using a specific payment method. The CRD provides that surcharges should be limited to the merchant’s cost resulting from the payment method chosen.

A precise definition of these costs will be the subject of consultation and the Government will publish guidance on the categories of fees that merchants will be able to include in a payment surcharge following consultation.

For the purposes of this impact assessment, it is assumed that only the direct costs to a merchant of collecting a payment (such as invoiced merchant service charges, terminal rentals, software upgrades, and telecoms costs) will be surchargeable. Merchants also incur direct payment costs through fraud checks and meeting information security standards for handling cardholder information.

It is not envisaged that general administrative overheads or other indirect costs (such as staff training) will be surchargeable. Indirect costs should be included in the headline price, as they are for any general overhead.

The merchant services charges are to a certain extent determined by multilateral interchange fees which are set by the card networks. Further merchant service charges vary depending on types of card; sales channels (online, face-to-face, electronic point of sale or mobile terminal); the card scheme (e.g. Visa/MasterCard/ American Express/Maestro); there may be a pro rata fee or percentage applied to the transaction, a fixed processing fee and an interface fee. Fees also vary depending on sales volume.

Complex software and staff training would be required to implement an accurate cost-reflective card surcharging mechanism at the level of individual transactions. This is because it is not possible for a merchant to:

(a) forecast card use precisely, so it is not possible to quote charges in advance with complete precision, and

(b) identify a specific card type and its associated fee when fees cannot be unbundled or disaggregated by a merchant.

If an attempt were made to surcharge by individual card and transaction type, and calculate the associated fees in real time, consumers would not know in advance what charge they might expect to pay, and they would face a bewildering variety of (to a consumer) seemingly random variable charges. It is therefore envisaged that traders and other organisations should be able to pass on the direct card costs through payment surcharges at a higher level of aggregation and timeliness than at the level of individual transactions. This would enable for example, a simple and fairly stable flat surcharge (expected to be charged for debit card payments) or a pro rata surcharge (expected to be charged for credit card payments) to be levied on card transactions, if merchants chose to do so.

Merchants would be allowed to decide whether to levy different surcharges depending on the card type (MasterCard, Visa, electron, embossed etc.) or a simple cost-reflecting surcharge on all types of cards.

It is expected that, given a stable and relatively low level merchant service charge (for processing a payment) payable by merchants on debit card transactions (around 20-50p), it will not be worthwhile for the majority of merchants to impose a separate payment surcharge on debit card transactions.

Costs to business

There are no direct costs to those sectors that do not impose a payment surcharge.

There would be no direct costs on the card networks, on acquirers or payment service providers or intermediaries or consumers

Following discussions with the card industry, web merchants, the British Retail Consortium and independent experts, it is expected that the direct one-off costs of a ban on above-cost payment surcharges would be borne by the merchants that impose payment surcharges and take advantage of the above-cost payment surcharge. As all the current surcharging merchants will lose a part of the payment surcharges' revenues (because some payment surcharges are higher than direct costs), they are expected to raise the headline prices or apply an alternative (transparent) charge in compliance with the Consumer Protection from Unfair trading Regulations 2008. Some may decide not to apply a surcharge at all. There is expected to be no additional costs to these businesses. This is because:

(a) Merchants recalculate and adjust prices frequently (some airlines adjust prices in real time). A change in one price factor in the multi-factor pricing calculation is virtually costless;

(b) Merchants already make frequent systems changes to update prices, and keep track of card types and the card numbering (BIN) system. In many cases prices are updated hourly or daily.

(c) a transition period of up to 6 months will give merchants more than enough time to factor pricing changes into their routine price updates, systems upgrades and maintenance;

(d) For the same reason, consequential changes to web pages are also virtually costless. This is because web pages are under continuous development. The marginal cost of removing or updating the surcharge price display is a negligible simplification and cannot be separated from other regular changes and updates (bearing in mind that merchants will be required to display all their charges transparently and will also need to make changes to reflect this under existing legislation);

(e) There are no consequential impacts on back-end systems or administration.

The one-off costs of this measure are therefore expected to be reduced to near zero<u> For illustrative purposes, if it were desired to isolate the specific one-off *notional* cost of making an individual system change, it is likely to be one or two hours of programming time at around £185 per hour = £370 per firm.</u>

Ongoing cost impacts

There would be no ongoing direct costs once merchants had adjusted their prices and pricing methodology.

Costs to regulators

There is expected to be a small increase in costs to the enforcement authorities.

Enforcers specified under Part 8 of the Enterprise Act 2002 will be granted powers to apply to the courts for enforcement orders, which will prohibit future specified conduct which would breach the payment surcharges provision. However, we expect enforcers to aim to obtain voluntary undertakings from traders before pursuing court action, which will be a last resort.

We anticipate that enforcers will only initiate action in high-profile cases where consumer detriment is high and a voluntary undertaking by the trader to change their practices could not be obtained.

Consumers will be able to report businesses that are not complying with the legislation. The enforcer will add these reports to its log of information and then look at the complaints to decide on areas that might require it to monitor traders' activities or to investigate further. Any additional logging costs will be absorbed within the enforcer's existing budgets. The costs of any enforcement action will be met from the enforcer's existing budget.

In addition to powers under Part 8, Trading Standards and the DETINI will have a duty to consider complaints and a power to apply for injunctions to secure compliance, under a proposed specific injunctions regime. These costs would be unlikely to be significant and would come from their existing budgets. The legal costs of a High Court action may be borne by the party that loses such an action. We do not anticipate a high volume of such cases because the value of over-paid payment surcharges would be relatively low.

Consumers will also be able to pursue non-compliant merchants through the small claims procedure.

National and Local Government costs

Central and local government will be covered by the provision when they are providing goods or services within scope of the legislation on a contractual basis to consumers (such as local authority sports facilities).

Debit card fees are not applied by national or local government to any significant degree.

Credit card fees are applied by some local councils and agencies to recover the costs they incur in accepting credit card payments.

These bodies are complying with the principle of full cost recovery and are not applying excessive, above cost payment surcharges. They will not therefore be affected by a ban on excessive payment surcharges, and there will be no consequential behavioural or market impacts.

The potential costs of this measure to local and national government is therefore zero

Relative prices and behavioural changes

Currently, credit card surcharges are typically higher than debit card surcharges. This corresponds with the difference in direct costs for merchants to process a credit or debit card payment. After introducing a ban on above-cost payment surcharges, it is expected that merchants will either impose no (or a small) surcharge on debit card payments in particular. The relative difference between the surcharge on a credit compared to a debit card payment is likely to remain substantial. While the relative cost of payment by credit card may decline where surcharges are currently excessive, there will be no additional incentive for most of the consumers to change their behaviour in terms of preferred payment method.

However with greater transparency and competition, consumers are likely to take their business to those that offer the best price, indicating not a transfer from business to consumer but from inefficient firms to those that are more efficient, improving overall allocative efficiency. Search costs to consumers in trying to find the true total cost of a good is reduced as firms provide total costing upfront, at negligible cost to merchants, this in turn may cause consumers to change their behaviour, stimulating demand.

Competition impacts

The on-line competitive environment will be enhanced by better price transparency.

Enabling traders to signal to customers the relative costs of different payment methods through a cost-reflective surcharge is economically efficient.

These effects cannot be quantified.

Benefits

The principal benefits are that:

- Consumers will be less misled by payment surcharges that are separate from the headline prices.
- Payment surcharges will reflect the cost incurred by the merchants only. Firstly, the aggregate level of surcharges may decrease significantly. Secondly, cost-related surcharges will enable customers to see the relative price of specific payment methods.
- This measure is intended to be part of a broader package of measures undertaken by the OFT within existing legislation to make prices and charges transparent at the outset of a transaction, rather than being built up in stages as a transaction progresses. This "drip pricing" practice is assessed as having the main potential to mislead customers[7].

These benefits cannot be directly quantified. The scale of the potential benefits depends on the extent of behavioural and pricing changes.

The benefits cannot be directly quantified, and are mostly qualitative. One useful quantitative proxy to indicate the gross value of surcharges that consumers will be made more aware of is the level of credit and debit card surcharges, which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential qualitative (non-cash) benefits to consumers through increased transparency.

[7] 2010, OFT Study - Advertising of Prices

OPTION 3: implement OFT recommendation to ban debit card surcharges in full in 2013 but repealed in June 2014.

Summary

Costs: This option is expected to impose no additional costs on business. This is because a transition period of up to 6 months would give merchants adequate time to factor pricing changes into their routine price updates, systems upgrades and maintenance. The background to this is the same as for option 2. There is expected to be a small increase in regulatory costs.

Merchants are unlikely to want to, or be able to, forego the revenues from surcharging debit cards. They are likely to respond by raising their headline price or other charges (for example admin or booking fees or delivery charges). The overall impact of a debit card surcharge ban would then be price neutral.

There is likely to be a distributional impact on the volume of payments put through debit cards, if consumers perceive debit cards to be a 'free' way to pay. The proportion of debit card to credit card purchases would rise by less than 0.7%.

Benefits: Consumers who hold debit cards will have at least one 'free' method of payment. They will no longer be misled by unavoidable payment charges that are separate from the headline prices, enabling them to compare prices and shop around more easily. Better price comparability will enhance competition.

Leaving businesses free to surcharge non-debit card transactions will also help to apply competitive pressure to merchant service charges and in turn on card interchange fees on credit card payments that are not visible to businesses or consumers.

The benefits cannot be directly quantified. One useful quantitative proxy is the level of debit card surcharges which were worth between £166 million and £230 million in 2010. The level of surcharges that were cost reflective was between £88-£122 million in 2010, implying a potential benefit of £78-£108 million for debit cardholders alone.

Assumptions

- **SMEs/ start-ups exempted:** it is assumed that the moratorium on new regulation for micro-businesses and start-ups will apply until June 2014.
- **Business to business and third sector:** Debit card fees are not applied in business-to-business and third sector transactions to any significant degree.
- **Central and Local Government:** Debit card fees are not applied by national or local government to any significant degree. It is assumed that central and local government will be exempt, except for those local government services that are provided on a contractual basis to consumers (such as local authority sports facilities).
- **Other sectors:** Debit card surcharges apply disproportionately in the transport sector, and particularly in the airline sub sector. Most other sectors do not appear to levy debit card surcharges to any significant extent. It is expected that businesses that apply payment surcharges in other sectors are mostly SMEs and will be exempt. Therefore this option impacts almost exclusively on the transport sector.
- **This provision would be repealed in June 2014 and replaced by Article 19 CRD.**

Costs to business

There are no direct costs to merchants that do not charge for debit card payments.

The direct costs of a debit card surcharge ban would be borne by the merchants that impose these surcharges only. These would be the one-off costs of making systems changes to update their websites and simplify their pricing by removing debit card surcharges. Merchants already make frequent systems changes to update their websites and prices, and keep track of card types and the card numbering (BIN) system. In many cases, prices are updated hourly or daily.

The Government proposes to introduce a transition period of up to 6 months, so that larger merchants (or their service providers) have sufficient time to factor any necessary systems/pricing changes into their routine price updates, systems upgrades and maintenance. SMEs and start-ups will be exempted until June 2014.

As merchants would incur the cost of reviewing and updating prices and undertaking system maintenance in any event, the one-off costs of this measure are therefore expected to be reduced to near zero. This is because the one-off costs of making price changes due to a payment surcharge ban cannot in practice be separated from other routine price updates. They would simply be one factor among a large number of pricing factors to be taken into account. SMEs would have until June 2014 to make pricing changes. For illustrative purposes, if it were desired to isolate the specific one-off *notional* cost of making a system change, it is likely to be one or two hours of programming time at around £185 per hour = £370 per firm.

There would be no direct costs on the card networks, on acquirers or payment service providers or intermediaries or consumers.

In June 2014 this provision would be repealed and replaced by Article 19 CRD. Businesses wishing to change their practices at that time would be likely to incur costs.

Ongoing cost impacts

There would be no ongoing direct costs once merchants had adjusted.

Costs to regulators

There is expected to be a small increase in costs to the enforcement authorities.

Enforcers specified under Part 8 of the Enterprise Act 2002 will be granted powers to apply to the courts for enforcement orders, which will prohibit future specified conduct which would breach the payment surcharges provision. However, we expect enforcers to aim to obtain voluntary undertakings from traders before pursuing court action, which will be a last resort.

We anticipate that enforcers will only initiate action in high-profile cases where consumer detriment is high and a voluntary undertaking by the trader to change their practices could not be obtained.

Consumers will be able to report businesses that are adding payment surcharges for using debit cards. The enforcer will add these reports to its log of information and then look at the complaints to decide on areas that might require it to monitor traders' activities or to investigate further. Any additional logging costs will absorbed within the enforcer's existing budgets. The costs of any enforcement action will be met from the enforcer's existing budget.

In addition to powers under Part 8, Trading Standards and the DETINI will have a duty to consider complaints and a power to apply for injunctions to secure compliance, under a proposed specific injunctions regime. These costs would be unlikely to be significant and would come from their existing budgets. The legal costs of a High Court action may be borne by the party that loses such an action. We do not anticipate a high volume of such cases because the value of over-paid payment surcharges would be relatively low.

Consumers will also be able to pursue non-compliant merchants through the small claims procedure.

Pricing impacts

This option assumes that the costs incurred by businesses in processing debit card payments (around 20-50p per transaction) should be treated as part of the cost of doing business and included in the headline price.

The specific cost burden to a business (represented mainly by the Merchant Service Charge) depends on the business' average transaction value, transaction frequency, security risks, exposure level, online turnover and how long it has been trading.

If SMEs are exempted it is not expected that businesses will have any difficulty in reflecting debit card fees in their headline price as a general overhead, just as many merchants currently do for the costs of handling cheques or cash, and paying cash into a bank account. However, those businesses that currently impose payment surcharges well above the cost of processing debit card payments will need to make a significant price adjustment.

Feedback from merchants and the card industry, the BRC and independent experts suggests that businesses in the service sectors where payment surcharges are common are unlikely to want to, or be able to, forego the revenues from surcharging debit cards. For example, the airlines that will be most affected are low cost carriers and charterers that have a target level of profits, partly determined by shareholders expectations for this sector. Nor do they have a significant business or first class passenger base that might absorb the effect of a ban on debit card surcharges. If they are unable to protect their revenues and profits by surcharging card payments, they are most likely to change their pricing structures via a higher headline price, or via alternative non payment-related charges (for example admin fees, delivery charges, or optional extras). This applies equally in the ferry sector and ticketing, where there is intense competition between merchants. Costs have been pared back and there is no alternative revenue stream to protect profit margins. There may not therefore be a significant reduction in overall prices. The overall impact of a debit card surcharge ban would then be price neutral.

Relative prices and behavioural changes

There is likely to be a distributional impact between the volume of payments put through debit cards and other forms of payment, if consumers perceive debit cards to be a simpler or 'free' way to pay (for example where there continues to be a surcharge on paying by credit card).

Many consumers who might otherwise have paid by credit card and now switch to a debit card payment would give up the protection afforded by s75 of the Consumer Credit Act[8] (although they may still benefit from protection under the "Chargeback" scheme).

If such a behavioural response occurs, then merchants are likely to face lower costs through the lower fees payable to card issuers on debit card transactions.

In the sectors where payment surcharges predominate, debit card transactions accounted for around 77% of transactions in 2010, and credit cards accounted for around 23%.

The potential scale of a switch from credit to debit card for online payments ranges from zero to a maximum of 100% of credit card transactions (every adult holds a debit card). In practice not all customers would wish to switch from credit to debit card. For example, they may wish to spread their payments, keep their Consumer Credit Act protection, or be committed to a particular credit card reward programme.

The range of potential changes is illustrated in the table below.

<u>Potential decrease in merchants' costs through a higher proportion of debit card transactions</u>

Estimated number of debit card transactions before the switch	153.9 m. transactions
Potential switch of up to 100% of credit card transactions	53.4 m. transactions
Midpoint estimate (50%)	26.7 m. transactions

Lower card processing costs Based on a switch of 26.7 mil transactions from credit to debit cards	
lower	- £16.82 m.
upper	- £99.88 m.
midpoint	- £58.35 m.
HM Treasury estimates, 2011	

Merchants may therefore save in the region of an £58.35 million per annum in card processing costs if credit card users switch to debit cards. This represents a potential decrease in price level, in a form of either headline prices or other surcharges (for example the booking surcharge). As evidence[9] shows, merchants often keep savings as additional revenue rather than passing them onto consumers, In this case, there would be no impact on the price level.

There will be a corresponding negative impact on acquirers' revenues as these are beneficiaries of the card processing fees.

Consequently, there will be an impact on payment card issuers as well because there is a significant difference between the multilateral interchange fee on debit vs. credit card transactions.

[8] Section 75 of the Consumer Credit Act makes a card company jointly and severally liable for any breach of contract or misrepresentation by the merchant on transactions between £100 and £30,000.

[9] 2010, Potential Introduction of Surcharging in France: Impact Study by Edgar, Dunn & Company – there is no evidence of retail price reductions when payment acceptance costs for merchants decline

Market impacts

- Any change in the distribution of transactions between debit and credit cards (and other card types like prepaid and charge cards) will affect the relative volume of business put through each card network. VISA has 86% of all the debit cards in issue[10] and would be expected to benefit from a switch to debit cards. This is likely to affect less than 0.7% of credit card transactions.
- Leaving businesses free to surcharge non-debit card transactions will help to counteract the market power of the card networks. Enabling consumers to see the true cost of processing a payment transaction would put direct pressure on the card companies to compete on price. This will apply competitive pressure to merchant service charges and in turn on card interchange fees that are not visible to businesses or consumers.

The distributional and market effects cannot be predicted with any accuracy, as the potential behavioural changes by consumers depend on merchants' actions which are themselves uncertain and likely to vary from merchant to merchant and sector to sector.

There is already some evidence that merchants are changing their practices in anticipation of legislation, for example, some airlines have begun to offer surcharge free debit card purchases.

Benefits

The principal benefits are that:

- Consumers will have at least one 'free' method of payment. 85 million debit cards are currently in issue[11] and 45 million people (89%) of adults have one. The OFT considers debit cards to be the standard on-line payment method, and a ban on debit card surcharges would help to establish this.
- Debit card users will no longer be misled by unavoidable payment surcharges that are separate from the headline prices. This will support efforts by the Government to make prices and charges transparent at the outset of a transaction, rather than being built up in stages as a transaction progresses. This "drip pricing" practice is assessed as having the main potential to mislead customers[12].
- Consumers paying with a debit card will be able to compare prices and shop around more easily. Better price comparability will enhance competition, particularly in the transport sector where payment surcharges are most prevalent. This will have wider benefits, in terms of facilitating e-commerce.
- Businesses would be able to impose transparent payment surcharges on other forms of payment that cost more to process and offer discounts on forms of payment that cost less.

These benefits cannot be directly quantified. The scale of the potential benefits depends on the extent of behavioural and pricing changes.

The benefits cannot be directly quantified. One useful quantitative proxy is the level of debit card surcharges which were worth between £166 million and £230 million in 2010. The level of surcharges that were cost reflective was between £88-£122 million in 2010, implying a potential benefit of £78-£108 million for debit cardholders alone.

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[10] Payments Council Annual Statistics 2010. Table 8.1
[11] Payments Council Annual Statistics 2010. Table 6.1
[12] 2010, OFT Study - Advertising of Prices

Option 4:

Ban payment surcharges altogether on all types of cards and other payment methods across all economic sectors (in 2013) and repeal in 2014 to be replaced by CRD provision.

Summary

It is expected that the direct administrative one-off costs of a ban on payment surcharges would be borne by the merchants that impose payment surcharges. There would be no direct costs on the card networks, on acquirers or payment service providers or intermediaries or consumers.

Costs: This option is expected to impose no additional costs on business. This is because:

(i) Micro enterprises will be exempt until June 2014;

(ii) Merchants recalculate and adjust prices frequently (some airlines adjust prices in real time). A change in one price factor in the multi-factor pricing calculation is virtually costless;

(iii) a transition period of up to 6 months will give merchants more than enough time to factor pricing changes into their routine price updates, systems upgrades and maintenance;

(iv) For the same reason, consequential changes to web pages are also virtually costless. This is because web pages are under continuous development. The marginal cost of removing or updating the surcharge price displayed is a negligible simplification and cannot be disentangled from other regular changes and updates (bearing in mind that merchants will be required to display all their charges transparently and will also need to make changes to reflect this under existing legislation).

(v) There are no consequential impacts on back-end systems or administration.

There is expected to be a small increase in regulatory costs.

There would be no direct costs on the card networks, on acquirers or payment service providers or intermediaries or consumers.

Benefits: Consumers will not be misled by payment surcharges that are separate from the headline prices, enabling them to compare prices and shop around more easily. Better price comparability will enhance competition.

By tying surcharges to the cost incurred by the merchants, surcharges may decrease significantly as they are mostly above the merchant service fee paid by the merchant. Furthermore, cost-related surcharges will enable customers to see the relative price of specific payment methods which may result in empowering merchants negotiating lower merchant service fees with the acquirers.

These benefits cannot be directly quantified. One useful quantitative proxy is the level of credit and debit card surcharges which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential quantitative (non-cash) benefits to consumers.

Background

This option would go further than Option 3 by extending a complete ban on payment surcharges from debit cards to payment surcharges on all forms of payment method, and further than the excessive payment surcharges ban announced by the Government in December 2011. This would not be compatible with the CRD and would therefore need to be repealed and replaced by the CRD provision in 2014.

Assumptions

- **SMEs/start-ups exempted:** It is assumed that in general, a total payment surcharge ban will apply to all commercial sectors. The moratorium on new regulation for micro-businesses and start-ups will apply until June 2014.
- **Business to business and third sector:** Debit and credit card fees are not applied in these sectors to any significant degree.
- **Central and local government:** It is assumed that central and local government will be exempt, except for those local government services that are provided on a commercial basis (such as local sports facilities).

- **Other sectors:** The majority of retailers do not apply payment surcharges in face-to-face transactions. Payment surcharges apply predominantly to on-line and telephone transactions. Payment surcharges for credit cards as well as debit cards are applied mainly in the transport sector, particularly by airlines, ferry companies, travel agents, and ticketing agencies. However, some other businesses apply payment surcharges, such as cinemas, theatres and concert venues, sports events, budget hotels, car parks and a few estate agents and car rental merchants.

Costs to business

There are no direct costs to those sectors that do not impose a payment surcharge.

The direct one-off costs of a complete payment surcharge ban would be borne by the merchants that impose these surcharges only, including those who only apply cost-reflective payment surcharges. There would be no direct costs on the card networks, on acquirers or payment service providers or intermediaries or consumers.

The direct costs to merchants would be the one-off costs of making system changes to simplify their pricing by removing payment surcharges. Merchants already make frequent systems changes to update their websites, prices, and keep track of card types and the card numbering (BIN) system. In many cases, prices are updated hourly or daily. The Government proposes to mitigate any additional one-off costs by exempting small merchants from the payment surcharge ban, and by introducing a transition period of 6 months, so that larger merchants (or their service providers) have sufficient time to factor any necessary pricing changes into their routine price updates, systems upgrades and maintenance. As merchants would incur the cost of reviewing and updating prices and undertaking system maintenance in any event, the one-off costs of this measure are therefore expected to be reduced to near zero. This is because the one-off costs of making price changes due to a payment surcharge ban cannot in practice be separated from other routine price updates. They would simply be one factor among a large number of pricing factors to be taken into account. SMEs would have until June 2014 to make pricing changes. For illustrative purposes, if it were desired to isolate the specific one-off *notional* cost of making a system change, it is likely to be one or two hours of programming time at around £185 per hour = £370 per firm.

Ongoing cost impacts

There would be no ongoing direct costs once merchants had adjusted but they may choose to amend their pricing practices in June 2014.

Costs to regulators

There is expected to be a small increase in costs to the enforcement authorities.

Enforcers specified under Part 8 of the Enterprise Act 2002 will be granted powers to apply to the courts for enforcement orders, which will prohibit future specified conduct which would breach the payment surcharges provision. However, we expect enforcers to aim to obtain voluntary undertakings from traders before pursuing court action, which will be a last resort.

We anticipate that enforcers will only initiate action in high-profile cases where consumer detriment is high and a voluntary undertaking by the trader to change their practices could not be obtained.

Consumers will be able to report businesses that are not complying with the legislation. The enforcer will add these reports to its log of information and then look at the complaints to decide on areas that might require it to monitor traders' activities or to investigate further. Any additional logging costs will be absorbed within the enforcer's existing budgets. The costs of any enforcement action will be met from the enforcer's existing budget.

In addition to powers under Part 8, Trading Standards and the DETINI will have a duty to consider complaints and a power to apply for injunctions to secure compliance, under a proposed specific injunctions regime. These costs would be unlikely to be significant and would come from their existing budgets. The legal costs of a High Court action may be borne by the party that loses such an action. We do not anticipate a high volume of such cases because the value of over-paid payment surcharges would be relatively low.

Consumers will also be able to pursue non-compliant merchants through the small claims procedure.

Pricing impacts

This option assumes that the costs incurred by businesses in processing payments should be treated as part of the cost of doing business and included in the headline price.

It is not expected that businesses will have any difficulty in reflecting their costs of collecting payments in their headline price as a general overhead. Most already do so. However, those businesses that currently impose payment surcharges will need to make a significant price adjustment.

Feedback from merchants and the card industry, the BRC and independent experts suggests that businesses in the service sectors where payment surcharges are common are unlikely to want to, or be able to, forego the revenues from surcharging payment cards. For example, the airlines that will be most affected are low cost carriers and charterers that have a target level of profits, partly determined by shareholders expectations for this sector. Nor do they have a significant business or first class passenger base that might absorb the effect of a ban on payment surcharges. If they are unable to protect their revenues and profits by surcharging card payments, they are most likely to change their pricing structures via a higher headline price, or via alternative non payment-related charges (for example admin fees, delivery charges, or optional extras). This applies equally in most other sectors, where there is competition between merchants. There may not therefore be a significant reduction in overall prices. Compared to Option 3, payment surcharges will be banned on both debit and credit card payments and the proportion of debit and credit card transactions may not be influenced. It will be easier for merchants to quantify lost revenues and increase the headline prices. The overall impact of a payment surcharge ban would then be price neutral.

Relative prices and behavioural changes

As credit card surcharges are typically higher than debit card surcharges, this option will have a larger absolute and relative effect on headline prices than option 3. The businesses levying the highest credit card surcharges, and the consumers that pay them, will be most affected.

The effect of a complete ban on payment surcharges will be to spread the different costs of each form of payment more uniformly across all customers. In the majority of cases, where payment costs are already distributed in this way, there will be no change. But there will be a change where there is currently a payment card surcharge that must be removed. As payment surcharges apply mainly to on-line payments, the effect will be felt, if it is felt at all, by consumers paying by card, on-line. In these cases, customers paying by debit card may face a relative price increase compared to those paying by credit card (because debit card surcharges are currently often lower than credit card surcharges).

Once the cost to consumers of paying by debit or credit card is equalised, there is likely to be a behavioural change, with some consumers incentivised to switch from debit to credit card, in order to take advantage of the protection afforded to credit card purchases by s75 of the Consumer Credit Act[13]. If such a behavioural response occurs, then merchants are likely to face an increase in costs through the higher card processing fees payable to card issuers on credit card transactions.

Potential switching from debit to credit cards: In the sectors where payment surcharges predominate, debit card transactions accounted for around 77% of transactions in 2010, and credit cards accounted for around 23%.

The potential scale of a switch from debit to credit card payments ranges from zero to a maximum of 64% of debit card transactions (64% of the adult population holds a credit card or charge card). In practice, not all consumers will wish to or be eligible to, switch in this way. The range of potential changes – illustrated in the table below.

<u>Potential increase in merchants' costs through a higher proportion of credit card transactions</u>

Estimated number of credit card transactions before the switch	53.4 m. transactions
Potential switch of up to 64% of debit card transactions	98.5 m. transactions
Midpoint estimate (32%)	49.25 m. transactions

[13] Section 75 of the Consumer Credit Act makes a card company jointly and severally liable for any breach of contract or misrepresentation by the merchant on transactions between £100 and £30,000.

Additional card processing costs Based on a switch of 49.25 mil transactions from debit to credit cards	
lower	£31.02 m.
upper	£190.19 m.
midpoint	£110.61 m.
HM Treasury estimates, 2011	

Merchants may therefore incur in the region of an additional £110 million per annum in card processing fees. It is expected that the merchants will increase their headline prices or other surcharges to cover these additional costs.

There will be a corresponding positive impact on acquirers' revenues as these are beneficiaries of the card processing fees.

Consequently, there will be a positive impact on payment card issuers as well because there is a significant difference between the multilateral interchange fee on debit vs. credit card transactions.

Competition and market impacts

A change in the relative price of using credit and debit cards that encourages consumers to switch towards using credit cards will change the volumes of business put through each card network. A switch to credit cards may benefit MasterCard at the expense of Visa and others, as the former dominates the debit card market in the UK.

Preventing merchants from signalling to customers the relative costs of different payment methods will not prevent merchants from continuing to negotiate attractive rates in the highly competitive market for payment services. However, it is likely to affect the delicate competition dynamics of the card market and may enable the card companies to introduce more expensive cards, such as reward cards, and raise their fees more easily.

There is already some evidence that merchants are changing their practices in anticipation of legislation, for example, some airlines have begun to offer surcharge free debit card purchases.

These effects cannot be quantified.

Benefits

The principal benefits are that:

- Consumers will no longer be misled by unavoidable payment charges that are separate from the headline prices. This will support efforts by the Government to make prices and charges transparent at the outset of a transaction, rather than being built up in stages as a transaction progresses. This "drip pricing" practice is assessed as having the main potential to mislead customers[14].
- No matter which payment method used, consumers will be able to compare prices and shop around more easily. Better price comparability will enhance competition, particularly in the transport sector where payment surcharges are most prevalent. This will have wider benefits, in terms of facilitating e-commerce.
- Consumers who avoided paying by credit card because of a higher surcharge imposed will be enabled to switch to another payment method without any additional fee charged by the merchant.
- The prices will be easier to understand as there won't be any differences according to the payment method chosen. This will benefit especially those customers who aren't able to differentiate between a debit and a credit card.
- Merchants will save on implementation costs – there will be no need to explain to the customers when there is a surcharge and when not.
- There may be less disputes solved by the enforcement authority (OFT) resulting in decrease in costs.

[14] 2010, OFT Study - Advertising of Prices

These benefits cannot be directly quantified. The scale of the potential benefits depends on the extent of behavioural and pricing changes.

One useful quantitative proxy is the level of credit and debit card surcharges which were worth between £316 million and £630 million in 2010. This could be taken to represent the upper ceiling of the value of potential quantitative (non-cash) benefits to consumers.

Annexes

Annex 1: Transaction and surcharge estimates

Table 1a: Credit and debit card transactions per sector

Credit cards	Lower	Upper	Midpoint
Airlines	84,096,702	189,685,458	136,891,080
Ferries	14,758,406	107,229,047	60,993,726
Rail	24,453,000	48,906,000	36,679,500
Leisure	27,120,600	54,241,200	40,680,900
Total credit cards	150,428,709	400,061,704	275,245,206

Debit cards	Lower	Upper	Midpoint
Airlines	139,212,652	164,907,901	152,060,276
Ferries	12,651,665	37,954,995	25,303,330
Rail	8,398,000	16,796,000	12,597,000
Leisure	5,327,790	10,655,580	7,991,685
Total debit cards	165,590,107	230,314,476	197,952,291

Table 1b: Credit and debit card surcharges per sector

Total cards	Lower	Upper	Midpoint
Airlines	£223,309,354	£354,593,358	£288,951,356
Ferries	£27,410,071	£145,184,042	£86,297,056
Rail	£32,851,000	£65,702,000	£49,276,500
Leisure	£32,448,390	£64,896,780	£48,672,585
Total	£316,018,816	£630,376,180	£473,197,498

Sector	Debit cards	Credit cards	Total
Airlines	£152,060,276	£136,891,080	£288,951,356
Ferries	£25,303,330	£60,993,726	£86,297,056
Rail	£12,597,000	£36,679,500	£49,276,500
Leisure	£7,991,685	£40,680,900	£48,672,585
Total	£197,952,291	£275,245,206	£473,197,498

Annex 2: Assumptions for debit/credit card switching

In the options proposed, consumers may choose to switch between forms of payment if they perceive debit (credit) cards to be a simpler or 'free' way to pay (for example where there continues to be a surcharge on paying by credit card).

The effect of switching was calculated by estimating the number of transactions for each payment type in 2010 for a number of sectors:

:

Sector	Debit cards	Credit cards	Total
Airlines	24,461,756	7,431,016	31,892,772
Ferries	13,930,738	4,231,893	18,162,632
Rail	73,112,000	26,182,000	99,294,000
Leisure	42,385,200	15,561,000	57,946,200
Total	**53,405,909**	**153,889,694**	**207,295,603**

An upper bound was assumed for the proportion of people switching from a debit to credit card or a credit to debit card. As 64% of adults in the UK have a credit or charge card, this was assumed to be the upper bound for switching from a debit to a credit card. Conversely, since every credit card holder also has a debit card, it was assumed that the upper bound for switching from credit to debit cards was 100%.

The distributional effect was worked out by using 2010 data as a baseline for the volume of transactions. For instance, when estimating the effect of a switch from a debit to credit card on transactions in the airline sector:

Before:		**After:**	
Debit cards:	24,461,756	Debit cards:	8,806,232
Credit cards	7,431,016	Credit cards	23,086,539

Once the new transaction volumes were estimated, a lower and upper bound were assumed for processing costs based on OFT estimates. These estimates for costs were applied to the number of transactions (before and after) to work out the processing costs, and the amount saved by switching (the difference).

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