Title: Payment Surcharges **IA No:** BIS0380 **Lead department or agency:** Department of Business, Innovation and Skills **Other departments or agencies:** HM Treasury	**Impact Assessment (IA)**
	Date: 03/12/2012
	Stage: Final
	Source of intervention: Domestic
	Type of measure: Secondary legislation
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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**
-£0.31m	-£0.31m	£0.31m	Yes	IN

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 causes detriment to consumers as they cannot effectively compare prices to secure the best deals. The dilution of price transparency weakens competition and over time will tend to inhibit innovation and growth.

What are the policy objectives and the intended effects?

The policy objectives are:-

- Increase price transparency, increasing consumer's ability to choose effectively between different products and services
- Payment surcharges to become more cost reflective, steering consumers to the most efficient payment method

The intended effects are to remove barriers to effective competition both for the products and services being purchased as well as competition between payment methods.

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** Yes	**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: [signature] Date: 18/12/12

Summary: Analysis & Evidence

Preferred Option

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:** -0.31

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	0.31		0	**0.31**

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

The transition cost for business is expected to be small, £310k, 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 costs on the card networks, intermediaries or consumers.

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

There is no expected reduction in net revenues. There may be a small reduction in demand as customers become aware of the full price earlier in the buying process. However, offsetting this may be reduced fears of an unexpected large price rise at the end of the transaction.

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'

n/a

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

- Consumers will make better informed decisions reducing consumer detriment;
- Consumers will be able to compare prices more easily, boosting competition in areas where surcharges are common;
- Payment surcharges will become more cost-reflective, steering consumers to the most efficient payment method;
- The overall price level may fall, however this is considered unlikely.

Key assumptions/sensitivities/risks

Discount rate (%) n/a

Businesses are expected to compensate for lost payment surcharge revenue with either a rise in headline prices or alternative additional charges (or a combination of the two). Although not changing the overall price, this will make prices more transparent. The behavioural changes following a rise in transparency of the overall price are unknown. It is assumed that a higher price upfront will reduce demand, but increasing consumers' confidence that there will not be unexpected large additional costs added at the end of the buying process will increase demand and these two factors will broadly offset.
Greater price transparency will enable consumers to be able to make better informed decisions. In addition greater transparency reduces the search costs and thus strengthens effective competition.
There is a risk that transition costs are higher than expected.

BUSINESS ASSESSMENT (Preferred Option)

Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs: 0.31	**Benefits:** 0	**Net:** -0.31	Yes	IN

Evidence Base (for summary sheets)

What is the problem under consideration?

1. Excessive payment surcharges reduce price transparency resulting in consumer detriment and weaker competition. Excessive charges revealed at the end of a transaction are a form of drip pricing, which occurs when extra charges are added as consumers go through the buying process. A 2010 study by the Office of Fair Trading (OFT) titled "Advertising of Prices" found that drip pricing led to the highest detriment of all the price frames and caused consumers to make purchasing and searching errors.[1]

   "The reason that partitioned pricing works to increase sales is because consumers 'anchor' on the piece of information they consider most important, for example the advertised price, and adjust insufficiently for any additional charges, thereby underestimating the total price. People also have a desire to be consistent with their previous actions (known as the 'commitment and consistency' principle) which means that even when the price starts to increase they tend to remain committed to the trader."

   Source: Office of Fair Trading, "Advertising of prices", December 2010

2. The OFT also found that consumers had a negative emotional reaction to drip pricing.

3. In addition to the direct effects on consumers, drip pricing can also reduce competition by making it harder to compare prices. The OFT report found that when faced with drip pricing consumers were less likely to shop around. This happens because it takes additional time and effort to find out true prices and consumers assume that all businesses will add similar charges. The higher the additional charges are the greater the effect on competition.

4. Increasing competition should bring long term benefits as competition is generally associated with greater choice, lower prices, and better quality goods and services.

5. There are some benefits to drip pricing, for example it allows consumers to choose features they value most and avoid paying for options they do not require.[2] However, these benefits are reduced if additional charges do not reflect the cost of options.

6. In June 2011, in response to a super-complaint received from Which?, the OFT 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.

7. In July 2012, the OFT closed its investigation in to airline payment surcharges. Most airlines gave formal undertakings to the OFT, and others made changes to their pricing practices and these changes were accepted in lieu of undertakings by the OFT. These changes, combined with those made voluntarily by other airlines before and during the investigation, mean that free payment by debit card will be the industry standard for UK passengers.

8. The OFT has recommended that the Government should introduce measures to prohibit retailers from surcharging altogether on payments made by debit cards to ensure a meaningful and consistent solution across the economy (this is option 3). The EU Consumer Rights Directive (CRD) bans above-cost surcharges on any payment method and is to be implemented by June 2014. The problem under consideration therefore is what to do before the CRD is implemented.

Options within the Consumer Rights Directive

9. The CRD allows member states to exempt low-value, off-premises transactions, such as taxis and doorstep sales, from the scope of the directive. Member States can set this threshold at a value up to 50 Euros (Article 3(4) CRD). Allowing these excessive payment surcharges would be undesirable for the same reasons as set out above and it could be argued that it is even more undesirable for a

[1] Office of Fair Trading, "Advertising of prices", December 2010
[2] Office of Fair Trading, "Advertising of prices", December 2010

trader to apply high payment surcharges to low value transactions. It is therefore our intention that off-premises contracts of all values will be covered by the legislation on excessive payment surcharges.

10. The CRD also lists certain sectors that are not covered by the directive (see consultation document for full list). These sectors will not be covered by the UK legislation in accordance with the Government's presumption that generally it should not "gold-plate" EU law by extending the scope of EU legislation beyond what is required to meet our EU obligations. The exception to this is for package holidays which will be covered by the ban on above cost payment surcharges. Not including package holidays in the ban would create an obvious inconsistency between package holidays and their components, for example air travel, where payment surcharges will be prohibited.

Methodology

11. 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.
12. 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 Surcharges

13. 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.

14. 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

15. 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.

Discounts

16. 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.

Where are payment surcharges currently applied?

17. **Overall:** There are fewer payment surcharges on consumers paying with cash, cheque or credit transfer in the UK. Evidence suggests that a 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[3] that 19% of businesses that accepted card payments surcharged at least one

[3] 2007 OFT survey of 1,052 businesses across the UK that accept card payments, including retailers, wholesalers and public sector bodies.

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.

18. **Retailers** largely do not apply payment surcharges at the point of sale. The EDC survey[4] 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.[5]

19. **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 microbusinesses will be exempted from a surcharging ban until June 2014 as part of the Government's moratorium on new regulation for microbusinesses. 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 microbusinesses to continue to recover the reasonable direct costs they incur in accepting card payments.

20. **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.

21. **Business to business:** payment surcharges are not common practice.

22. **Third sector:** payment surcharges are not common practice.

23. **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.

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

Estimated total value (£m) of card surcharges in the principal affected sectors in 2010

	Lower estimate	**Upper estimate**	**Midpoint**
Airlines	223.3	354.6	289.0
Ferries	27.4	145.2	86.3
Rail	32.9	65.7	49.3
Leisure	32,.5	64.9	48.7
Total	316.0	630.4	473.2

HM Treasury estimates based on market research, 2011

4 2010 Potential Introduction of Surcharging in France: Impact Study by Edgar, Dunn & Company

5 2011 OFT Payment surcharges - Response to the Which? super-complaint

Totals (Mid-points) by card type (£m)

	Debit cards	Credit cards	Total
Airlines	152.0	136.9	289.0
Ferries	25.3	61.0	86.3
Rail	12.6	36.7	49.3
Leisure	8.0	40.7	48.7
Total	198.0	275.2	473.2

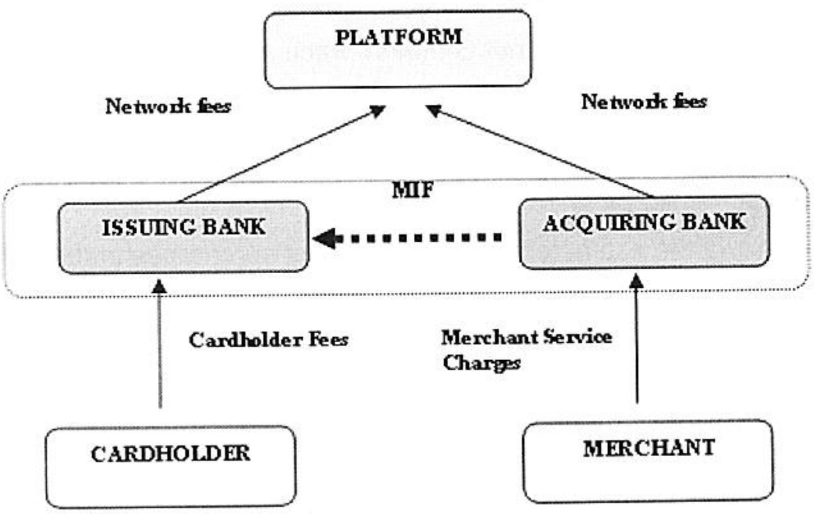
HM Treasury estimates based on market research, 2011

Costs of taking payment by debit or credit card

The four-party model

25. 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 seller's bank is called the acquiring bank (or acquirer). 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.

26. 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

27. There are several types of cost borne by the merchant when accepting a card payment. These include[6]:

- **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;
- **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;

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

- **Delayed Receipt of Funds** – represents 2 - 5% of the costs as a consequence of banks (acquirers) delaying settlement with the merchant;
- **Risk management** – represents 1 - 2% of the costs and include various risk and fraud prevention mechanisms, and compliance with industry security standards;
- **Fraud losses** and charge backs– represents up to 3% of the costs and mostly affect on-line merchants;
- **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.

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

29. **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.

30. 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.

31. **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.

32. 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

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

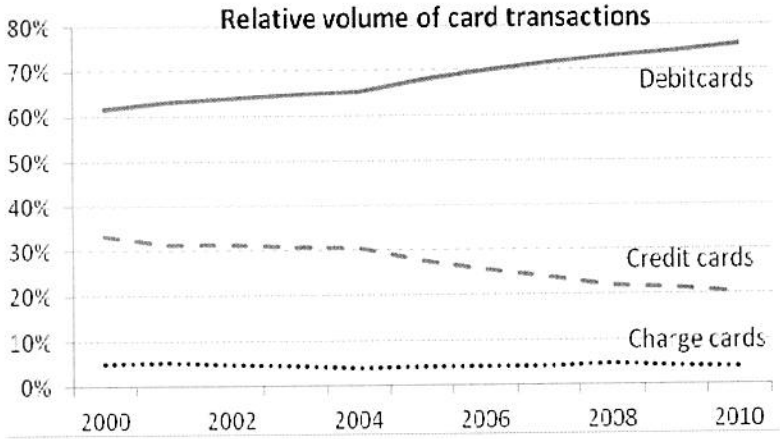
Illustrative costs of processing card transactions (travel providers)								
Transaction size, corresponding merchant service cost (as % of the transaction size)								
Card type	£50		£100		£250		£500	
Credit card	£1.16	(2.3%)	£2.10	(2.1%)	£4.94	(2.0%)	£9.66	(1.9%)
Charge card	£1.52	(3.0%)	£2.84	(2.8%)	£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

34. The volume and value of card transactions in 2010 was

UK Card Transactions in 2010				
	Volume (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				

35. 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[7], 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.



Forecasts: 2010 - 2020

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

[7] 84,642 debit cards compared to 55,601 credit cards in 2010. Payments Council annual statistics. 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.

36. The assessment of option one is the same as for option 2 with the following exceptions:

1. The costs and benefits would be delayed by roughly a year.
2. Medium and large scale enterprises would benefit from a longer implementation period (until June 2014) compared to Option 2 (until 2013). There is no difference in treatment for smaller enterprises.

Option 2: (the preferred option)

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

Details

37. 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 are made clear to customers at the beginning of a transaction. The OFT will consider extending their 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) and that customers can compare prices. Some companies operating in the airline sector, where card surcharges are commonplace, have already started shifting the way prices are presented to consumers.

What costs would be allowed in the surcharge

38. 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.

39. The costs to be taken into account are the direct costs that can be attributed to taking a particular form of payment; for card payments this would include merchant service charges, IT and equipment costs, processing fees, fines and penalties imposed by card companies, together with any operational costs arising from activities dedicated exclusively to card payments. To assist business, BIS will publish guidance on the kinds of costs traders can lawfully include in a payment surcharge.

40. 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.

41. 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.

42. 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.

43. 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:

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

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

44. 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.

45. 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.

46. 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.

Further assumptions

47. 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.

48. 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.

49. 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).

50. 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.

Impact on firms' revenues

51. There is no expected reduction in net revenues. Banning excessive payment surcharges will lead to one (or a mix) of two responses from businesses:

    i) a corresponding increase in charges earlier in the buying process

    ii) a reduction in overall prices

52. 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. As such, businesses are expected to recoup any lost revenue from surcharges earlier in the buying process, e.g. through higher headline prices.

53. When customers become aware of the full price earlier in the buying process there may be a small reduction in demand. This is because of the removal of anchoring and the effect of the 'commitment and consistency' principle discussed in the earlier "what is the problem under consideration?" section. It is likely to be small because the charges are relatively small compared to the total price and many consumers have come to expect them. There may also be a counterbalancing increase in demand due to the greater certainty around the final price. Again this effect is likely to be small and it is expected that they will roughly balance out leaving firms' revenues unchanged.

54. There may be an additional effect on competition in sectors where some participants charge surcharges and others don't – for example, while supermarkets don't charge surcharges some small shops do. In these sectors those firms that currently charge excessive surcharges may not be able to raise prices enough to fully compensate for lost surcharges. While some individual firms may lose business, the overall impact on revenue will be very small as consumers will be switching to cheaper alternatives rather than not buying at all. Also this would be an efficiency gain as prices would now be more reflective of costs and not be cross subsidised from excessive surcharges.

55. While further research may make the impact on revenue clearer, it would be disproportionately difficult to quantify. This is because firms would be the best source of such information, but it would be unlikely that they would admit that excessive payment surcharges have allowed them to charge costumers higher overall prices. It also reflects the fact that the overall market response will depend on the interaction of consumer and firm behaviour, which is inherently uncertain.

Costs:

Costs to business

56. As discussed above, there is not expected to be any cost to business in terms of lost revenue.

57. It is expected that the one-off, transition costs of a ban on above-cost payment surcharges would be small for firms because:

- Offline firms will just alter the amount charged manually at the point of sale.
- Merchants already make frequent systems changes to update prices, and keep track of card types and the card numbering (BIN) system. A change in one price factor in the multi-factor pricing calculation is relatively low cost;
- The plan to ban excessive surcharges was announced in December 2011;
- The resulting 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;
- There are no consequential impacts on back-end systems or administration.

58. The consultation impact assessment included an illustrative cost of £370 per firm based on two hours of IT programming. Consultation respondents didn't question the figure, but did note that the transition wouldn't be costless. We discussed this figure further with a payment industry expert, who felt it was reasonable, but suggested the inclusion of additional costs for an hour of testing. Using the same hourly rate as for the programming gives a per-firm cost of £555.

59. The gold-plating of the CRD comes in two forms - the early implementation and the extension to cover low value off premise sales and the package holiday sector.

60. The early implementation of a ban on excessive payment surcharges could impact small, medium and large scale enterprises, of which there are 214,155 in the UK private sector.[8] However, many of these businesses are in sectors unlikely to charge payment surcharges, for example manufacturing, restaurants and temporary employment agencies. Removing firms in Standard Industrial Classification (SIC) groups that we consider unlikely to be currently charging payment surcharges leaves around 60,000 firms. The SIC groups are still quite broad, for example freight transport by road is in a group with removal services. This means to include removal services where payment surcharges to consumers seem feasible, we have had to include freight transport which would almost certainly be unaffected by this measure. An OFT survey in 2007 found that over 80 per cent of merchants did not levy a surcharge for either consumer credit or debit cards. This figure was for the entertainment and travel sectors, two sectors where surcharging is more common. Applying this percentage to all sectors leaves an estimate of around 11,000 firms affected. As we have applied the figure for a sector where surcharging is common to all sectors including those where surcharging is far rarer, this 11,000 figure should be treated as a very conservative estimate. Further investigation into the exact number of firms would be disproportionate given the small impact it has (because the costs are also incurred in the baseline option).

61. Using this maximum figure of 11,000 firms affected gives a maximum implementation cost of £6.3m. This figure would be incurred in the baseline option as well – in 2014 with the implementation of the CRD. This means the additional cost of early implementation is just 3.5% of the total cost i.e. one year's worth of discounting. This gives an NPV figure of £220k, which is also a one-off cost to business.

62. Off premises sales involve a face-to-face transaction and as such surcharges are likely to be applied manually. Thus there will be no additional cost of reducing the size of the surcharge applied. (As outlined in paragraphs 51-52, we expect there won't be a reduction in revenue).

63. Many package holiday firms that add a surcharge will do so manually, particularly very small firms, and as such will face no additional cost of reducing the size of the surcharge applied. It is larger package holiday firms that are likely to have to make the kind of adjustments to systems outlined in paragraph 57. There are 800 firms in the travel agency and tour operator activities SIC group with ten or more employees.[9] Assuming again the £555 cost outlined in paragraph 57 and that only around 20% of firms charge surcharges (see paragraph 59) gives a one-off cost of £90k, which is also a one-off cost to business. (As outlined in paragraphs 51-52, we expect there won't be a reduction in revenue).

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[8] BIS Business Population Estimate for the UK and Regions (start 2012)

[9] BIS Business Population Estimate for the UK and Regions (start 2012)

64. The total transition cost is £310k, which is also a one-off cost to business. £220k comes from implementing the CRD early and £90k comes from extending the CRD to cover low value off premise sales and the package holiday sector.

Costs to National and Local Government

65. 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).

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

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

68. 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.

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

Costs to regulators

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

71. 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 that 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.

72. 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.

73. 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.

74. In addition to powers under Part 8, Trading Standards and the Department for Enterprise, Trade and Investment Northern Ireland 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. 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.

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

Benefits

76. The principal benefits are that:

- Consumers will make better informed decisions reducing consumer detriment.
- Reduced emotional impact from drip pricing;
- 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.
- The overall price level may fall where payment surcharges currently exceed the costs of collecting a payment, however this is considered unlikely.

77. These benefits have not been quantified. The scale of the potential benefits depends on the extent of behavioural and pricing changes and further exploration of these effects would be disproportionately difficult as discussed above.

78. However, there is considerable theoretical support for the suggestion that greater price transparency should drive more effective markets and stronger competition. For example, as discussed in

paragraphs 1-3, a 2010 study by the Office of Fair Trading (OFT) titled "Advertising of Prices" found that drip pricing led to the highest detriment of all the price frames and caused consumers to make purchasing and searching errors.[10] The report also found that consumers had a negative emotional reaction to drip pricing and were less likely to shop around reducing competition.

[10] Office of Fair Trading, "Advertising of prices", December 2010

OPTION 3:

Implement OFT recommendation to ban debit card surcharges in full in 2013 but repealed in June 2014.

There would be no restrictions on credit card surcharges.

Assumptions

79. As for option two with the addition that **this provision would be repealed in June 2014 and replaced by Article 19 CRD.** This is because the CRD requires maximum harmonisation meaning that Member States are not permitted to make or maintain national measures which provide either a greater or lesser level of consumer protection than Article 19. Even if the CRD were not going to be implemented this would not be the preferred option due to the risk that debit cards are not or will not be the cheapest payment method (see paragraph 81).

Impact on firms' revenue

80. As the allowable surcharge for debit cards in option 2 would be quite small (the OFT's illustrative cost, shown in paragraph 33, is £0.53), this option differs only slightly from option 2. Although there would be no restriction on credit card surcharges, unlike in option 2, firms will not be able to charge excessive surcharges due to the option of free payment by debit card. Thus for the same reasons as in option 2 there is no expected reduction in net revenues.

Impact on relative use of different types of payment cards

81. There may be an increase in the volume of payments made by debit cards relative to other methods, if consumers perceive debit cards to be a simpler or 'free' way to pay where there continues to be a surcharge on paying by credit card. However, this effect is likely to be negligible because:

- The price differential between the payment types is unlikely to change. Excessive credit card surcharges are unlikely because consumers will have the option of paying by debit card for free. Also the cost of processing debit card payments will be included in the headline price for all transactions, including transactions paid for by credit cards, which will also push down the level of credit card surcharge.
- There are benefits to paying by credit card, including delayed settlement, increased legal protection and rewards, such as cash back and air miles.

82. While this analysis applies when debit cards are the cheapest method, this may not be the case for all businesses. It could also constrain the introduction of cheaper payment methods, although this risk is negligible given that the restraint would be removed with the introduction of the Consumer Rights Directive in 2014.

Costs

Costs to business

83. The costs to business will be similar to option 2 with no change in revenue and small transition costs (although there would be a second set of transition costs in June 2014 when this provision would be replaced by Article 19 CRD).

Costs to regulators and national and local government

84. These are expected to be the same as for option 2 – a small increase in costs for regulators and no extra cost for national and local government.

Benefits

85. The principal benefits are that:

- Consumers will have at least one 'free', commonly used method of payment. Consumers will be able to compare prices more easily, boosting competition in areas where surcharges are common. This effect would be slightly stronger than under option 2.
- 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. This may boost e-commerce.

- Consumers will make better informed decisions reducing consumer detriment.
- Reduced emotional impact from drip pricing;
- The overall price level may fall where payment surcharges currently exceed the costs of collecting a payment, however this is considered unlikely.

As with option 2, these benefits are not quantified.

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.

Assumptions

86. As for option two with the addition that **this provision would be repealed in June 2014 and replaced by Article 19 CRD.** This is because the CRD requires maximum harmonisation meaning that Member States are not permitted to make or maintain national measures which provide either a greater or lesser level of consumer protection than Article 19. Even if the CRD were not going to be implemented this would not be the preferred option, because of the economic inefficiency from not allowing more expensive payment options to attract higher charges (see paragraph 88).

Impact on business

87. Businesses, no longer able to charge more for credit card payments than those by debit cards, would have one of (or a mix) of three responses –

- <u>Forego the revenue from payment surcharges</u> - 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
- <u>Stop accepting credit cards</u> - In the many sectors where there is no price differential between debit and credit card payments, few firms choose not to accept credit cards. However, this approach may be taken in some sectors where consumers are very sensitive to price and may be easier for firms operating on the internet.
- <u>Increase prices for all consumers</u> – the most likely response.

Impact on relative use of debit and credit cards

88. This option would remove the difference in charges between using a credit card and using a debit card, and would therefore lead to an increase in people wanting to pay by credit card. This is because there are benefits to paying by credit card, including delayed settlement, increased legal protection and rewards, such as cash-back and air miles.

89. This switching will be economically inefficient as many people will pay by credit card despite their valuation of the additional benefits being less than the extra cost for business leading to an overall loss to society.

The potential scale of switching from debit to credit cards

90. 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**

91. In the sectors in the above table debit card transactions accounted for 74% of transactions in 2010, and credit cards accounted for 26%. The maximum assumed potential for switching is to 64% of all transactions because this is the proportion of the adult population that has a credit card or charge card (although, of course this figure could rise). This gives a maximum of 41% of all transactions switching from debit cards to credit cards. With a minimum of 0%, the midpoint estimate of switching is 21% of the total or 39.6m transactions.

Costs

Costs to business

92. Transition costs will be negligible as in option 2 (although there would be a second set of transition costs in June 2014 when this provision would be replaced by Article 19 CRD).

93. Business will have additional costs due to an increase in payments by credit card; 39.6m transactions switching from credit to debit cards are estimated to cost an additional £89m based on assumed processing costs based on OFT estimates. Businesses are likely to increase prices to compensate (as discussed in paragraphs 51-52), but may lose some sales as a result.

94. There is also a risk that the absence of credit card surcharges encourages card providers to provide more expensive cards increasing costs further.

95. An increase in card processing costs means that there will be increases in revenue for acquiring banks and payment card issuers.

Costs to consumers

96. As discussed above, businesses are likely to increase prices for all consumers in response to not being able to charge credit card users more. This means debit card users will lose out, although credit card users would benefit.

97. The additional £89m of payment costs as a result of more people using credit cards would also be borne by consumers.

Costs to national and local government

98. These are expected to be the same as for option 2. Although they would not be able to recover additional costs from people who use credit cards, they would likely be able to recover the increased costs from consumers as a whole.

Costs to regulators

99. These are expected to be the same as for option 2, a small increase in costs for regulators.

Benefits

100. The principal benefits are that:

- Consumers who pay by credit card are likely to face lower prices. Consumers who switch to credit cards will gain some benefits including delayed settlement, increased legal protection and rewards, such as cash back and air miles. The people who will gain least from switching will be those who are now indifferent and make no gain. The people who will gain most from switching will be those who were indifferent before between the cost and the benefit of paying by credit card and now the cost is removed gain a benefit equivalent to that cost. Assuming switchers are evenly distributed along such a spectrum, gives an estimated benefit of £49.5m i.e. half the increased cost from increased use of credit cards.
- 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 fewer disputes solved by the enforcement authority (OFT) resulting in decrease in costs.
- Consumers will be able to compare prices more easily, boosting competition and possibly e-commerce in areas where surcharges are common. This effect would be stronger than under option 2 and 3.
- Reduced emotional impact from drip pricing;
- The overall price level may fall where payment surcharges currently exceed the costs of collecting a payment, however this is considered unlikely.

As with option 2, these benefits are not quantified.