

HIGHLY CONFIDENTIAL – SUBJECT TO PROTECTIVE ORDER

**UNITED STATES DISTRICT COURT  
EASTERN DISTRICT OF NEW YORK**

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IN RE: AMERICAN EXPRESS ANTI-STEERING  
RULES ANTITRUST LITIGATION

This Document Relates To:  
CONSOLIDATED CLASS ACTION

11-MD-02221 (NGG) (RER)

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THE MARCUS CORPORATION,  
on behalf of itself and all similarly situated persons,

13-CV-07355 (NGG) (RER)

Plaintiff,

- against -

AMERICAN EXPRESS COMPANY et al.,

**REDACTED - PUBLIC VERSION**

Defendants.

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**REPLY DECLARATION OF ALAN S. FRANKEL, PH.D.**

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## 1. INTRODUCTION AND OVERVIEW

### 1.1. My Analysis of American Express's NDP and the Agreement

1. On April 10, 2014, I submitted a declaration (“Frankel Declaration”) concerning the proposed class settlement (“Agreement”) in this litigation between American Express and a settlement class consisting of the millions of U.S. merchants that accept American Express cards, under which American Express would partially relax its “non-discrimination policy” (“NDP”).<sup>1</sup> The Agreement follows settlements reached between a similar class of merchants and MasterCard and Visa in MDL-1720 under which merchants obtained the ability to surcharge MasterCard and Visa credit card transactions, with certain restrictions including linkage to the merchants’ ability to surcharge American Express card transactions (if the merchant accepts American Express cards and they are more costly than MasterCard or Visa credit cards).

2. American Express’s NDP currently prohibits a merchant from surcharging American Express card transactions unless the merchant surcharges all other card transactions, including those using debit cards, by at least as much as the merchant surcharges American Express card transactions. But MasterCard and Visa prohibit surcharging of their debit cards (and merchants generally would not want to surcharge debit cards, which are lower cost and the use of which merchants wish to encourage), so merchants that accept American Express cards generally cannot surcharge any credit cards. The Agreement would permit merchants to surcharge American Express card transactions so long as the merchant surcharges all *credit* cards by at least as much – i.e., the requirement that debit cards also be surcharged in order to

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<sup>1</sup> Declaration of Alan S. Frankel, Ph.D., April 10, 2014 (“Frankel Declaration”). My qualifications are described in the Frankel Declaration. My updated CV is attached in Appendix A.

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surcharge American Express cards will be removed.<sup>2</sup> Merchants still will be prohibited from surcharging American Express but not other credit cards or setting a higher surcharge for American Express cards than for other credit cards. I refer to this continued American Express restriction as its “no-differential surcharge” or “NDS” policy.

3. I concluded that “[a]lthough further liberalization [of American Express’s NDP] would benefit merchants, the relief obtained in the Agreement will significantly benefit merchants throughout the United States.”<sup>3</sup> I based my conclusion on a straightforward economic analysis built on the following logical steps and supported by the available evidence.

- Differential pricing or promotion at retail is a principal mechanism by which competition between merchants’ suppliers occurs.<sup>4</sup> Payment card networks like American Express have used anti-steering rules to suppress this basic competitive process with respect to the networks’ card acceptance services provided to and paid for by merchants.<sup>5</sup> Anti-steering rules are used by card payment networks to restrict competition, enhance market power, and maintain anticompetitively high merchant fees.<sup>6</sup>
- At the level of credit card fees prevailing in the United States, many merchants are likely to surcharge credit card transactions.<sup>7</sup>
- Surcharging permits merchants to recoup the cost of credit card payments directly from customers who use credit cards and set lower posted prices.<sup>8</sup>
- Surcharging credit card transactions will induce many customers to use alternatives, especially debit cards, which directly reduces merchant costs.<sup>9</sup>

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<sup>2</sup> Under the terms of the Agreement, American Express also may limit the amount of a merchant surcharge to the amount that the merchant pays to American Express to accept the card transaction. Class Settlement Agreement, January 7, 2014 (“Agreement”), p. 21.

<sup>3</sup> Frankel Declaration, ¶174.

<sup>4</sup> Frankel Declaration, ¶122.

<sup>5</sup> Frankel Declaration, ¶124.

<sup>6</sup> Frankel Declaration, ¶174.

<sup>7</sup> Frankel Declaration, Part 3.2.

<sup>8</sup> Frankel Declaration, Part 3.3.

<sup>9</sup> Frankel Declaration, ¶124 and Part 3.4.

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- The threat to networks of lost transaction volume from credit card surcharges will generate a previously suppressed competitive constraint on the level of credit card merchant fees.<sup>10</sup>
- The increased prevalence of credit card surcharging will tend to shift general payment preferences and patterns towards debit card use at all merchants, whether they surcharge or not.<sup>11</sup>
- Statutes that may restrict the ability to surcharge in some states may reduce, but not eliminate, the value of the right to surcharge all credit cards under network rules.<sup>12</sup>
- American Express’s NDP significantly reduces the number of merchants that can economically surcharge any credit card transactions even after the MDL-1720 Settlements, so that the economically relevant benefits from the Agreement extend beyond reductions in costs currently incurred to process American Express transactions, by permitting merchants more effectively to reduce all of their credit card transactions and fees.<sup>13</sup>

## 1.2. Professor Stiglitz’s Declaration

4. Professor Joseph Stiglitz has submitted a declaration on behalf of a group of major supermarket and drug store merchants (“Individual Merchant Plaintiffs”) that object to the Agreement and which are currently engaged in litigation with American Express over its NDP (and which previously litigated similar issues against MasterCard and Visa in MDL-1720).

5. Professor Stiglitz neither addresses nor disputes any of the elements of my analysis that show that merchants will benefit from the ability to surcharge all credit card transactions without surcharging debit card transactions. Professor Stiglitz’s opinions about

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<sup>10</sup> Frankel Declaration, Part 3.5. Professor Hausman oddly states, “Dr. Frankel makes no claims that the settlement will lead to reduced AMEX merchant fees.” Report of Professor Jerry Hausman, June 6, 2014 (“Hausman Report”), ¶9 (at p. 7). But I do believe that the settlement will lead to reduced fees by all of the credit card networks, including American Express, as I stated in my initial declaration. Frankel Declaration, ¶¶15, 24, 58, 65, and Professor Hausman elsewhere cites my conclusion to that effect (Hausman Report, ¶9 (at p. 5), ¶¶44, 57 (and disagrees with my conclusion)).

<sup>11</sup> Frankel Declaration, ¶¶15, 24.

<sup>12</sup> Frankel Declaration, Part 4.2.

<sup>13</sup> Frankel Declaration, Part 3.6.

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competition in card payment systems and the anticompetitive effects of anti-steering rules, which he has described in his previous reports, are very similar to my own, and should lead him to agree with me that the ability to surcharge credit card transactions is valuable to merchants and to the public.

6. In his declaration, Professor Stiglitz focuses instead on some elements of the Agreement – such as American Express’s ability to continue enforcing its NDS policy – which he contends cause the Agreement to harm merchants. As I explain, however, Professor Stiglitz is only correct if the alternative to the Agreement is assumed to be better, more valuable relief, not the status quo. A settlement is invariably a compromise, however, and I do not evaluate the Agreement relative to relief that I believe would most fully make the market competitive, rather I evaluate it relative to the status quo in determining that the Agreement benefits U.S. merchants.

### **1.3. Professor Hausman’s Report**

7. Professor Jerry Hausman has submitted a report on behalf of a group of 41 other merchants and merchant groups (“Constantine Cannon Objectors”) that object to the Agreement.

8. Professor Hausman and I agree about many of the competitive economic features of the payment card marketplace, but he disagrees with my conclusion that the ability to surcharge credit cards without surcharging debit cards under the terms of the Agreement will benefit U.S. merchants. Professor Hausman explains why American Express possesses significant market power, but he neither offers a diagnosis of any *conduct* he believes American Express has engaged in that has had significant anticompetitive effects in the United States nor

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prescribes any relief which might reduce or eliminate American Express's market power. In fact, it is unclear whether Professor Hausman's opinions, if accepted, could even be consistent with merchants succeeding in an antitrust case against American Express.

9. To explain, in MDL-1720, Professor Hausman contended that "[s]urcharging will not eliminate or discipline the market power exercised by Visa and MasterCard."<sup>14</sup> In that case and in his report here he contends that surcharging – even differential surcharging of American Express cards – has had *no effect* on the level of American Express merchant fees in Australia, where surcharging and differential surcharging have been common, and he claims that a far lower share of U.S. merchants are likely even to try surcharging card transactions in the United States. Thus, logically, Professor Hausman cannot argue that the continued American Express NDS policy is conduct that has a significant anticompetitive effect by preventing competition from reducing American Express's market power.

10. Professor Hausman credits the decline in American Express fees in Australia exclusively to merchants' ability there to discontinue acceptance of American Express cards (which he says merchants are less able to do in the United States) coupled with regulatory-mandated reductions in MasterCard and Visa interchange fees – *not* to surcharging of American Express cards.<sup>15</sup> But relief that would force MasterCard and Visa to reduce their credit card interchange fees is unavailable in a case being litigated against American Express (and American Express itself is a single corporate entity, and not one created by an association of banks that otherwise compete). American Express does not permit open competition among acquiring

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<sup>14</sup> Report of Professor Jerry Hausman, In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, May 28, 2013 ("Hausman MDL-1720 Report"), ¶10.

<sup>15</sup> Hausman MDL-1720 Report, ¶¶24, 65-71.

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banks to set the level of American Express merchant fees (and unlike MasterCard and Visa, American Express can control the pricing of all of its merchant agreements without any explicit interchange fee system).

11. Professor Hausman argued in MDL-1720 that “[m]ore extensive reform which eliminates the Honor All Cards (HAC), Honor All Issuers (HAI), and no bypass rules *is necessary to constrain* the supra-competitive interchange fees” of MasterCard and Visa.<sup>16</sup> He also identified “default interchange fee schedules” – fees MasterCard and Visa mandate flow from the merchant’s bank to the card issuing bank – as a “restrictive practice” of those networks. Many individual banks issue MasterCard and Visa credit cards, and Professor Hausman argued that if merchants could negotiate with individual member banks of MasterCard or Visa over the terms of acceptance of credit cards issued by those individual banks, then the merchants would be able to counter the market power otherwise exercised by MasterCard and Visa on behalf of themselves and their member banks collectively. But, although American Express has enlisted some U.S. banks to use American Express branded cards, it continues to control the merchant side of its network and the majority of American Express card issuing volume internally.<sup>17</sup>

12. In short, while Professor Hausman casts doubt on the value to merchants of the relief provided by the Agreement, he does not offer the prospect that antitrust litigation against American Express should produce a better result (or any positive result) for merchants. However, he is incorrect about the value of the ability for merchants to surcharge as provided for by the Agreement, as I will discuss further below.

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<sup>16</sup> Hausman MDL-1720 Report, ¶10 (emphasis added).

<sup>17</sup> “No bypass rules” refer to Visa restrictions on merchants and banks using an alternative to Visa to provide authorization, clearing, and settlement services in interbank Visa card transactions. There is no analogue in the American Express network because American Express is predominantly a unitary organization.

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## 2. ECONOMIC CONTEXT OF THE AGREEMENT

### 2.1. The Incremental Reform of Anti-Steering Rules

13. The NDP is American Express's version of anti-steering rules – requirements which impede or prohibit merchants from discouraging their customers' use of a more costly payment method (short of discontinuing acceptance of that method) or encouraging the use of less costly payment methods. In my initial declaration (as in my published research), I explained that anti-steering rules have had anticompetitive effects.

[C]ard networks use anti-steering rules (especially no-surcharge rules) to restrict competition, enhance market power, and maintain anticompetitively high merchant fees. In my view, merchants should be free to compete with other merchants over the terms of sale, including any surcharges, discounts, or other incentives with respect to payment methods.<sup>18</sup>

14. Anti-steering rules have taken a variety of forms. Card networks originally prohibited merchants accepting credit cards from treating customers using those cards less advantageously than the merchant treated any other customers – including cash customers. Legislation has relaxed some aspects of American Express's NDP and similar rules of other card networks. In the early 1980s, the Cash Discount Act permitted merchants to offer discounts to customers who use cash.<sup>19</sup> In 2010, the Dodd-Frank Act expanded that to permit merchants to offer discounts to customers who use cash, checks, or debit cards – overriding network rules to the contrary – and permitted merchants to require a minimum purchase amount (up to \$10) for use of credit cards.<sup>20</sup>

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<sup>18</sup> Frankel Declaration, ¶174.

<sup>19</sup> Public Law 97-25, July 27, 1981, Sec. 101.

<sup>20</sup> Public Law 111-203, July 21, 2010, Sec. 1075.

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15. Under the card networks' rules, merchants were still effectively prohibited from offering discounts (or similar benefits) to users of one brand of credit cards but not others, or adding a surcharge to any credit card transactions. With respect to brand-specific credit card discounts, the United States Department of Justice brought an action against MasterCard, Visa, and American Express, and reached a settlement with MasterCard and Visa under which those networks permit merchants to offer discounts to customers who use alternative brands of credit cards. American Express maintains its prohibition, however, and the Department of Justice and American Express are currently litigating the issue.<sup>21</sup>

16. Until recently, and with only very limited exceptions, MasterCard and Visa prohibited surcharges on the use of their respective credit card brands. Discover Card requires that a merchant can only surcharge Discover Card transactions if the merchant also surcharges other credit card transactions by at least as much as the merchant surcharges Discover Card transactions.<sup>22</sup> American Express prohibits a merchant from surcharging American Express card transactions unless the merchant also surcharges all other credit card *and debit card transactions* by at least as much.

17. In 2012, MasterCard and Visa agreed to relax their no-surcharge rules as part of their respective settlements with a merchant class ("MDL-1720 Settlements"). In particular, those networks agreed to permit a merchant to surcharge MasterCard or Visa card transactions, but only if the merchant also surcharges more costly credit cards (i.e., typically

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<sup>21</sup>

<sup>22</sup> Discover, Merchant Operating Regulations, October 14, 2011, DFS0809209 at '226.

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American Express) by at least as much. The MDL-1720 Settlements permits MasterCard and Visa to continue their prohibitions of surcharges on MasterCard or Visa debit card transactions (and merchants generally would be unlikely to want to surcharge debit cards which are much less costly than credit cards). But American Express forbids merchants from surcharging American Express card transactions *unless they also surcharge debit cards*. Thus, if a merchant accepts American Express cards, it typically cannot surcharge any credit cards.

18. As I explained in my initial declaration, the absence of relief from American Express's linkage of credit card surcharges to debit card surcharges significantly attenuated (but did not eliminate) the value of the relief in MDL-1720.<sup>23</sup> Relief from the American Express linkage of surcharges of its cards to surcharges on debit cards would make credit card surcharges a more practical option for many merchants. Indeed, objectors to the MDL-1720 Settlements cited the American Express linkage between credit and debit card surcharges as a reason why they claimed that those settlements would provide no benefit to merchants.<sup>24</sup> Professor Hausman likewise cited that linkage as a reason why most U.S. merchants would not surcharge credit cards and so would not, in his view, benefit from the MDL-1720 Settlements.<sup>25</sup>

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<sup>23</sup> Frankel Declaration, ¶¶63, 74; see also See, Declaration of Alan S. Frankel, Relating to the Proposed Class Settlement, April 11, 2013 ("Frankel MDL-1720 Declaration"), Part 4.6.2 and Reply Declaration of Alan S. Frankel, Ph.D., Relating to the Proposed Class Settlement, August 16, 2013 ("Frankel MDL-1720 Reply Declaration"), Part 4.4.2.

<sup>24</sup> As National Retail Federation argued in objecting to the MDL-1720 Settlements, "In order to surcharge, retailers must be willing to sacrifice their business relationship with American Express – which few if any can afford to do." National Retail Federation Statement of Objection to Final Approval of the Proposed Rule 23(B)(2) Agreement, In Re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, May 28, 2013 ("NRF MDL-1720 Objection"), pp. 5, 18-19

<sup>25</sup> Hausman MDL-1720 Report, ¶¶64-67. Unlike the Constantine Cannon Objectors, the National Retail Federation and Professor Hausman, the Independent Merchant Plaintiffs supported the MDL-1720 Settlements, arguing that while additional relief against American Express was important to obtain, the relief with respect to MasterCard and Visa no-surcharge rules was nevertheless valuable. Richard Arnold in MDL-1720 Fairness Hearing, September 12, 2013, pp. 44-48.

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The Agreement will now eliminate American Express’s linkage of credit card and debit card surcharging, so merchants that accept American Express cards (which collectively account for a large share of retail sales)<sup>26</sup> can surcharge credit card transactions without dropping acceptance of American Express.

## 2.2. The Agreement *Liberalizes* Competition Relative to the Status Quo

19. Professors Stiglitz and Hausman (and the objectors) misleadingly suggest that the Agreement creates new anticompetitive restrictions that will harm merchants. Professor Stiglitz claims that the Agreement will [REDACTED] [REDACTED]<sup>27</sup> He cites, for example, the ability under the MDL-1720 Settlements for merchants to differentially surcharge at the “product” level – i.e., a different surcharge for premium MasterCard or Visa credit cards that cost the merchant more to accept than non-premium credit cards.<sup>28</sup> Professor Stiglitz contends that the Agreement “[REDACTED] [REDACTED]”<sup>29</sup> He explains:

[REDACTED]

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<sup>26</sup> [REDACTED]

<sup>27</sup> Declaration of Prof. Joseph Stiglitz, May 27, 2014 (“Stiglitz Declaration”), ¶26 (emphasis added).

<sup>28</sup> Stiglitz Declaration, ¶28.

<sup>29</sup> Stiglitz Declaration, ¶30. Although product-level surcharging is an option that I believe merchants should have, there are practical impediments with implementing such a strategy. In Australia, the Reserve Bank of Australia has encouraged merchants to engage in product-level surcharging but has found that few, if any, merchants use this strategy. See, Reserve Bank of Australia, “A Variation to the Surcharging Standards: Final Reforms and Regulation Impact Statement,” <http://www.rba.gov.au/payments-system/reforms/cards/201206-var-surcharging-stnds-fin-ref-ris/pdf/201206-var-surcharging-stnds-fin-ref-ris.pdf>, June 2012, p. 6.

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[REDACTED] .<sup>30</sup>

20. But American Express currently forbids *any* surcharging unless the merchant also surcharges all other card transactions, including debit card transactions, by at least the same amount. And the MDL-1720 Settlements did not eliminate the pre-existing MasterCard and Visa no-surcharge rules with respect to debit card transactions. Thus, under the status quo rules of these networks, only if a merchant drops acceptance of American Express cards can it typically surcharge *any* MasterCard or Visa credit cards by *any* amount.

21. Professor Stiglitz thus is not comparing the competitive strategies available to a merchant under the terms of the Agreement to the strategies available to them today. Instead, he is comparing their available options under the Agreement to a hypothetical set of *even better* options that would permit a merchant to engage in the more refined pricing strategies he describes, and which he says are foreclosed by the Agreement. Professor Stiglitz states that

“ [REDACTED]

[REDACTED]”<sup>31</sup> But that is not true. The Agreement eliminates a key American Express competitive restriction while not eliminating other restrictions. Its net effect cannot be to make the situation worse than it already is. It is only worse than it would be compared to a “but-for world” in which some or all of the remaining restrictions were also eliminated.

22. Professor Stiglitz is not alone in attributing anticompetitive effects to the Agreement rather than to the status quo. Professor Hausman states:

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<sup>30</sup> Stiglitz Declaration, ¶31.

<sup>31</sup> Stiglitz Declaration, ¶26 (emphasis added).

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The *proposed settlement will eliminate* any economic incentive for a merchant to attempt to steer business away from AMEX [and towards Visa, MasterCard, or Discover credit cards] using surcharges, since the permitted surcharge for AMEX can be no larger than the surcharges for VMC or Discover cards, even though the costs of those cards are lower than AMEX cards.<sup>32</sup>

23. Professor Hausman misleadingly claims that the *Agreement* will create “oligopoly behavior”<sup>33</sup> and provides American Express with *more* market power than it has today:

[S]ince merchants will not be permitted to surcharge AMEX credit-card transactions unless they also surcharge VMC credit-card transactions equally, I find it likely that AMEX *will increase its merchant fees* relative to VMC or Discover because AMEX knows merchants cannot steer consumers to VMC or Discover credit cards by not surcharging them or surcharging them less than AMEX credit cards.<sup>34</sup>

24. He suggests that the *Agreement* “*will lead to an anticompetitive outcome*” by permitting American Express to enforce its no-differential surcharging restriction<sup>35</sup> and states that “[a]n even worse possible result” of the *Agreement* is “the ‘price fix’ outcome” which he explains, means that “[s]ince AMEX and VMC will all realize that the allowed surcharge will be identical among the three cards, they may all increase their merchant fees.”<sup>36</sup>

25. The Constantine Cannon Objectors similarly state:

[T]he Proposed Settlement not only *eliminates the one benefit of surcharging*—the ability of at least some merchants to benefit from interbrand competition through differential surcharging—while [sic]

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<sup>32</sup> Hausman Report, ¶142 (emphasis added).

<sup>33</sup> Hausman Report, ¶161.

<sup>34</sup> Hausman Report, ¶151 (emphasis added).

<sup>35</sup> Hausman Report, Part VII section heading (emphasis added).

<sup>36</sup> Hausman Report, ¶162.

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*empowering American Express to raise its rates to further entrench its power.*<sup>37</sup>

26. Notwithstanding its earlier argument that the ability to surcharge MasterCard and Visa transactions provided by the MDL-1720 Settlements was not valuable to merchants due to a merchant's need to drop American Express cards to take advantage of it, the National Retail Federation similarly states that the Agreement "*affirmatively undercuts merchants' surcharging abilities,*"<sup>38</sup> because "merchants that wish to surcharge Amex must surrender their right to engage in the differential, interbrand surcharging that the MDL 1720 settlement permits."<sup>39</sup> But the Agreement does not permit American Express to *begin* enforcing a no-differential surcharge provision with respect to other credit card brands – American Express already enforces that policy without the Agreement. The NRF criticized the MDL-1720 Settlements because, with American Express' NDP in place, they said few merchants would surcharge at all. Now they suggest elimination of the American Express restriction is taking away a valuable option from merchants.

27. In fact, the Agreement provides a new option – surcharge all brands of credit cards but not debit cards – that merchants did not previously have. That cannot "lead to an anticompetitive outcome" or "[REDACTED]" or create a "price fix" outcome that lets American Express "increase its merchant fees" relative to what it would charge absent the Agreement. Relative to the status quo, the Agreement clearly does none of these things.

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<sup>37</sup> Memorandum of Law in Opposition to Motion for Final Approval of Settlement on behalf of: 7-Eleven, Inc., et al., June 6, 2014 ("CC Brief"), p 35 (emphasis added).

<sup>38</sup> Statement of Objections to the American Express Class Action Settlement of Absent Putative Rule 23(B)(2) Class Member National Retail Federation, May 21, 2014 ("NRF Statement of Objections"), p. 7.

<sup>39</sup> Id., p. 8.

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### 2.3. The Prospects for Further Competitive Reform and the Reasonableness of the Settlement

28. I explained in my initial declaration and revisit below why the ability to surcharge all credit cards will cause a relative shift of transaction volume to debit cards (and cash) and why that will benefit merchants. I agree with Professor Stiglitz that “no-differential surcharge” rules are anticompetitive and merchants should have the ability to establish whatever surcharges or discounts they wish in competition with other merchants.

29. American Express, MasterCard, and Visa all disagree, and they all have retained economic experts in this case or MDL-1720 previously who argue that the networks lack market power and their anti-steering rules are procompetitive and benefit the public. I believe that those arguments are incorrect. But any claim that the Agreement has anticompetitive effects by enabling American Express to enforce a no-differential surcharge policy implicitly is basing that claim on the assumption that the relevant status quo is not the actual world but rather a but-for world in which all aspects of American Express’s NDP have been eliminated. In other words, absent the Agreement some plaintiff will litigate or arbitrate to a successful verdict and obtain injunctive relief on behalf of *all merchants* in the United States (rather than a narrower injunction or settlement or one applicable only to a particular plaintiff) that permits all merchants to engage in differential surcharging, and that outcome is upheld on appeal. That requires a litigation risk analysis in addition to an economic analysis.<sup>40</sup> If it were certain that rejection of the Agreement would be followed quickly by even more effective competitive

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<sup>40</sup> Both Professors Stiglitz and Hausman avoid the litigation risk issue by making the extreme claim that the Agreement provides *no* benefits (so that *any* possibility of more complete relief is more valuable than the Agreement). Although I am confident that American Express’s NDP is anticompetitive and should be abolished, I have not undertaken a litigation risk analysis and have no opinion on the likelihood that a better outcome will materialize for the class as a whole if the Agreement is rejected.

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reforms applicable to the millions of merchants in the class, then it would make sense to reject the Agreement. But neither Professor Stiglitz nor Professor Hausman can provide any such certainty (and Professor Hausman does not even identify any anticompetitive American Express conduct).

30. Professor Stiglitz criticizes the Agreement on the grounds that the Agreement does not eliminate American Express's restrictions on merchants discounting other credit card brands or engaging in "soft steering."<sup>41</sup> But the United States Department of Justice is trying those issues in a separate case. Even in a but-for world setting (i.e., comparing the Agreement to an even better outcome rather than the status quo), to judge the Agreement as deficient on this basis is equivalent to assuming that if the Department of Justice loses its case, one or more merchants nevertheless would have subsequently prevailed and obtained market-wide relief on the same issues.<sup>42</sup> Moreover, I understand that the Department of Justice can still bring an action challenging remaining aspects of American Express's NDP.

### **3. MARKET DEFINITION, MARKET POWER, AND STEERING IN COMPETITIVE MARKETS**

#### **3.1. Market Definition**

31. Professor Hausman devotes considerable attention to the issue of market definition. Market definition is typically performed as a part of an indirect analysis of market power. From an economic perspective, market definition may not be particularly important when market power or anticompetitive effects of conduct (or relief from conduct) can be directly evaluated, as they can in this case. The Constantine Cannon Objectors and the National

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<sup>41</sup> Stiglitz Declaration, ¶¶27, 45.

<sup>42</sup> Moreover, if the Department of Justice fails to prevail in its case against American Express with respect to discounting, that presumably could affect the likelihood that a merchant would prevail with respect to surcharging.

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Retail Federation, however, use (or rather misuse) market definition in a purely semantic way to argue that merchants cannot benefit by steering customers from credit card transactions to debit cards – an issue I discuss in Part 4.4.

32. Although Professor Hausman and Professor Stiglitz (and Individual Merchant Plaintiff expert Dr. Christopher Velluro) have used somewhat different language to describe the relevant markets in the payment card industry, our respective analyses have been similar. In MDL-1720, I concluded that relevant antitrust markets exist for services provided to merchants separate from services provided to cardholders, for credit cards separate from debit cards, and – in part *because of the effects of network anti-steering rules* – for different brands of credit card or debit card acceptance services sold to merchants.<sup>43</sup> As I explained, “[a]nti-steering rules by their nature tend to create separate relevant markets since they reduce the substitutability of other payment methods.”<sup>44</sup> Even in a market defined to include all credit card acceptance services (or “network services”) sold to merchants, I explained that the loss of profits to most merchants from dropping any one brand, the inability to process one brand of card transactions using another network (and its fees), and the anti-steering rules, meant that market shares in the broader general purpose credit card network services market, standing alone, would tend to understate the degree of market power that each network could exercise.<sup>45</sup>

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<sup>43</sup> See, Report of Alan S. Frankel, MDL Docket No. 1720, July 2, 2009 (“Frankel MDL-1720 Report”), ¶11.

<sup>44</sup> Id., ¶150.

<sup>45</sup> Id., ¶15 (“Anti-steering rules have effectively divided the market so that each brand – MasterCard and Visa – of a particular type of card network service is supplied in a relevant market separate from the other brands. Equivalently... shares in the broader ‘market’ for general purpose card, offline debit card, and PIN debit card network services can tend to underemphasize each network’s market power, due to their anti-steering rules.”).

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33. Professor Stiglitz reaches the same conclusion as I did. In MDL-1720, he explained:

[REDACTED]

<sup>46</sup>

34. With respect to American Express, he similarly explains that “[REDACTED]

[REDACTED]

”<sup>47</sup>

35. Professor Hausman concludes that there is a relevant market for general purpose credit card network services (i.e., services to merchants).<sup>48</sup> His focus regarding market definition in this case is in distinguishing credit cards from debit cards, and he does not (in this

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<sup>46</sup> Expert Report of Joseph Stiglitz, Ph.D., In Re: Payment Card Interchange Fee and Merchant Antitrust Litigation, June 25, 2009, (“Stiglitz MDL-1720 Report”), ¶10(l). See also Expert Report of Dr. Christopher A. Velturo, In Re: Payment Card Interchange Fee and Merchant Antitrust Litigation, July 2, 2009 (“Velturo MDL-1720 Report”), ¶144

[REDACTED]

<sup>47</sup> Expert Report of Professor Joseph Stiglitz, In Re American Express Anti-Steering Rules Antitrust Litigation, April 2, 2013, (“Stiglitz Report”), ¶36. Dr. Velturo also reaches the same conclusions that he reached in MDL-1720. Expert Report of Dr. Christopher A. Velturo, In Re American Express Anti-Steering Rules Antitrust Litigation, April 3, 2013 (“Velturo Report”), ¶278.

<sup>48</sup> Hausman Report, ¶120; Hausman MDL-1720 Report, ¶27.

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case) explore whether the market can be defined even more narrowly (to single brands) due, for example, to the card networks' anti-steering rules.<sup>49</sup> In a case brought by the New Zealand Commerce Commission against MasterCard and Visa in which both Professor Hausman and I served as experts on behalf of the Commission, Professor Hausman defined a relevant market consisting of MasterCard and Visa services provided to merchants. But he explained like I have that "[o]ne could define a more narrow market of Visa acquiring [i.e. merchant services] and similarly a market for MasterCard acquiring" and that "none of the subsequent economic analyses would change."<sup>50</sup> Professor Hausman also explained in New Zealand that instead of a single-brand market or a MasterCard-Visa credit card acquiring market, one could define a broader market for all brands of merchant credit card acquiring services (e.g., in New Zealand including American Express and Diners Club) without altering the economic analysis.<sup>51</sup>

36. Professor Stiglitz does not address the geographic extent of the market, but Professor Hausman and I agree that the relevant geographic market is the United States.<sup>52</sup>

37. In short, there is no substantive difference between my opinions and those of Professors Hausman and Stiglitz concerning market definition.

38. I will return to the implications of market definition (or lack thereof) for analysis of the effects of surcharging in Part 4.4.1.

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<sup>49</sup> His analysis of each network's market power and the need of most merchants to accept each of the major brands, however, is the same as mine, Professor Stiglitz's, and Dr. Velturo's. For example, he explains that MasterCard, Visa, and American Express "potentially... could compete against each other" regarding merchant fees but that "this competition has not occurred in practice." Hausman Report, ¶140.

<sup>50</sup> Brief of evidence of Professor Jerry Hausman (redacted open version) in Commerce Commission v. Cards NZ Limited, et al. and DSE (NZ) Limited, et al. v. Cards NZ Limited et al., 4 May 2009 ("Hausman NewZealand Brief of Evidence"), ¶14.19.

<sup>51</sup> Id., ¶14.20.

<sup>52</sup> Hausman Report, ¶138; Frankel Declaration, ¶173. Dr. Velturo states his understanding that [REDACTED] Velturo Report, FN140.

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### 3.2. Market Power

39. I agree with Professor Hausman and Professor Stiglitz that MasterCard, Visa, and American Express all possess market power.<sup>53</sup>

### 3.3. Steering in Competitive Markets

40. Professor Hausman, Professor Stiglitz, and I are in agreement that, as Professor Hausman puts it, “price differences through ‘surcharges’ or ‘discounts’ are common in the U.S. retail economy.”<sup>54</sup> However, Professor Hausman misleadingly asserts that “the proposed settlement prohibits just this type of competitive behavior” (referencing American Express’s no-differential surcharge policy).<sup>55</sup> As I explained in Part 2, however, it is American Express’s NDP that prohibits differential surcharges not merely between American Express cards and other brands of credit cards, but also between American Express cards and debit cards. The Agreement liberalizes the American Express policy by removing this link to debit cards. The MDL-1720 Settlement permits merchants to surcharge MasterCard and Visa credit card transactions if the merchant surcharges American Express transactions, and with the proposed change to American Express’s NDP under the terms of the Agreement, merchants will be able to surcharge American Express, MasterCard, and Visa credit card transactions.

## 4. PROFESSORS STIGLITZ AGREES WITH EACH ELEMENT OF MY ECONOMIC ANALYSIS AND PROFESSOR HUSMAN’S CRITICISMS HERE ARE UNPERSUASIVE AND INCONSISTENT WITH HIS EARLIER POSITIONS

41. In the remainder of this Reply, I explain why I believe that economic evidence and analysis shows that the ability to surcharge credit card transactions (equally) without a

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<sup>53</sup> Hausman Report, Part V; Stiglitz Declaration, ¶12 ( [REDACTED] ); Stiglitz MDL-1720 Report, ¶166 ( [REDACTED] ); Frankel MDL-1720 Report, Part 4.

<sup>54</sup> Hausman Report, ¶160; Stiglitz Declaration, ¶17; Frankel Declaration, Part 2.

<sup>55</sup> Hausman Report, ¶160.

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requirement to also surcharge debit card transactions will benefit U.S. merchants. Professor Stiglitz criticizes the Agreement but never addresses this central question. I show that he agrees with each element of my economic analysis that leads to my conclusion. Professor Hausman claims here that U.S. merchants won't surcharge credit cards, and surcharging credit cards would neither induce a relative shift of transaction volume to debit cards nor create any pressure on credit card networks to reduce their merchant fees. But he has previously agreed with me on these points. He distinguishes the usefulness of surcharging to U.S. merchants from its usefulness to merchants in Australia because the U.S. merchant sectors are highly competitive, but he has previously agreed that surcharging is beneficial even in competitive markets.

#### **4.1. Credit Cards are Substantially More Costly to Merchants Than Other Payment Methods, Including Debit Cards**

42. In my initial declaration, I showed that it costs U.S. merchants substantially more when a customer pays for a purchase with a credit card compared to the same transaction paid for using other payment methods, in particular, a debit card. American Express's merchant fees, on average, are higher than those for Discover Card, MasterCard, and Visa credit cards, but each of those (and the weighted average of them together) is substantially higher than the cost of accepting debit cards.<sup>56</sup> Neither Professor Stiglitz nor Professor Hausman disagree that credit cards cost merchants far more than debit cards.

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<sup>56</sup> Frankel Declaration, Part 3.1 and Figure 3.

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#### **4.2. At the Level of Credit Card Fees Prevailing in the United States, Many Merchants are Likely to Surcharge Credit Card Transactions**

43. In my initial declaration, I explained that many merchants are likely to adopt surcharges on credit card transactions as a strategy for coping with high credit card fees in this country, particularly given the significantly lower fees incurred to accept debit card transactions.<sup>57</sup> Professor Stiglitz agrees with me that the incentive for a merchant to surcharge increases with the level of merchant fees.<sup>58</sup>

##### **4.2.1. My Views About the Likelihood that Merchants Will Surcharge Credit Card Transactions Have Not Changed**

44. Professor Hausman contends that few U.S. merchants are likely to surcharge credit card transactions due to a “business stealing” effect in which merchants that do not surcharge credit card transactions gain customers and profits from those that do, which alienates credit card customers.<sup>59</sup> He states that I previously agreed with his analysis.<sup>60</sup> That is not correct. Professor Hausman suggests that the business-stealing impediment to surcharging is permanent, deters almost all merchants from surcharging (even at the level of credit card merchant fees prevailing in the United States), and essentially eliminates any benefits from the ability to surcharge. I have never agreed with that analysis. He cites part of a passage from a paper of mine published by the Reserve Bank of Australia (“RBA”) in suggesting that I agree that merchants are unlikely to surcharge, but in that passage I say merely that surcharging is not a *complete* solution to the legacy of anticompetitive effects of the Visa and MasterCard

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<sup>57</sup> Frankel Declaration, Part 3.2.

<sup>58</sup> Stiglitz Declaration, FN27 (in the context of American Express: “”).

<sup>59</sup> Hausman Report, ¶47.

<sup>60</sup> Hausman Report, ¶46.

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monopolies and their conduct over the decades, and Professor Hausman omits half of a sentence in which I explain that it is particularly difficult for merchants to communicate the availability of lower prices using payment methods other than credit cards if the credit card networks have other rules – which they did in the United States – that restricted merchants’ ability to promote their non-credit card prices.<sup>61</sup> In the paper cited by Professor Hausman, I explain at length why the ability to surcharge credit card transactions is an important competitive reform that benefits merchants and the public.

- “[C]ompetitive pressure on networks to constrain the amount of the interchange fee is more effective if a merchant can choose the network, reflect its relative costs in point-of-sale surcharges and discounts, or otherwise effectively influence consumers to choose the merchant’s preferred network. This is likely why the networks often deter or prohibit merchants from influencing payment choices.”<sup>62</sup>
- “Even merchants’ mere *ability* to impose surcharges on credit card transactions can have procompetitive effects.”<sup>63</sup>
- “*Prohibiting* surcharges therefore has anticompetitive effects.”<sup>64</sup>
- “Although merchants’ ability to surcharge will not prevent networks entirely from using interchange fees to artificially increase merchant fees, it will constrain the amount of overcharges imposed through interchange fees.”<sup>65</sup>
- “The ability to surcharge can increase the number of merchants accepting cards, pressure networks to reduce merchant fees, and induce consumers to make more efficient payment choices.”<sup>66</sup>

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<sup>61</sup> Alan S. Frankel, “Towards a Competitive Card Payments Marketplace,” Reserve Bank of Australia and Melbourne Business School, Payment System Review Conference, April 2008 (<http://www.rba.gov.au/payments-system/resources/publications/payments-au/paymts-sys-rev-conf/2007/5-compet-card-payment.pdf>) (“Frankel RBA Paper”), p. 53.

<sup>62</sup> Frankel RBA Paper, p. 52.

<sup>63</sup> Id., p. 53.

<sup>64</sup> Id.

<sup>65</sup> Id.

<sup>66</sup> Id., p. 54.

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- “Incremental reform of contractual restrictions, such as elimination of the no-surcharge and no-discrimination rules, is helpful and beneficial to the public, but may be insufficient to erode interchange fees to restore fully competitive pricing in the marketplace, given the four-party credit card duopoly and vertically integrated three-party card networks.”<sup>67</sup>

45. It is true, as I acknowledged in Australia, that “probably due to transaction costs - *with low enough fees*, most merchants will not surcharge,” but even in Australia, where merchant fees are significantly lower than in the United States, “the ability to surcharge and actual use by some merchants of surcharges can significantly constrain merchant fees or reduce consumer usage of the most expensive cards.”<sup>68</sup>

#### **4.2.2. The Evidence From Australia Supports a Conclusion that Many Merchants Will Surcharge Credit Card Transactions in the United States**

46. Professor Hausman agrees that the removal of no-surcharge rules in Australia is a “natural experiment” about the effects of such reforms.<sup>69</sup> In my initial declaration I presented information about the trend in merchant credit card surcharging in Australia. For this purpose, I relied on periodic surveys published by the Australian consulting firm East and Partners, the same source cited routinely by the Reserve Bank of Australia (“RBA”).<sup>70</sup> The East and Partners surveys do not provide comprehensive data on surcharging in Australia, but they show an unmistakable trend towards increased adoption of surcharging by Australian merchants.

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<sup>67</sup> Id., p. 58.

<sup>68</sup> Id., p. 35 (emphasis added). I have concluded from my research that in a fully competitive credit card industry there would not have been interchange fees in the MasterCard and Visa networks – i.e., transactions would have been settled at par between banks as are check transactions, and merchants would probably pay fees of less than half of one percent, on average, to accept credit cards. The Reserve Bank of Australia asked me to present a paper addressing whether reforms to the rules and structure of credit card networks now could be sufficient to attain a fully competitive market. It is in that context that I explained that reforms now – not retrospectively at the inception of the anticompetitive practices – would be beneficial but not likely a *complete* solution to the legacy of anticompetitive effects.

<sup>69</sup> Hausman Report, ¶152.

<sup>70</sup> Frankel Declaration, ¶137. See also, e.g., Reserve Bank of Australia, “Review of Card Surcharging: A Consultation Document,” June 2011 (“RBA June 2011 Consultation Document”), p. 2.

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47. Professor Hausman discounts the importance of the growing fraction of merchants that have adopted surcharging in Australia. He notes that in a payment panel study of Australian households undertaken by the RBA, respondents reported that they paid surcharges on only 5% of their credit card transactions in both 2007 and 2010.<sup>71</sup> He claims that “it is the volume of transactions that are surcharged which provides the important economic factor.”<sup>72</sup> I disagree. The percentage of merchants that actually surcharge credit cards is clearly relevant to a claim that merchants will not surcharge credit cards. Moreover, in Australia, the largest merchants obtained very substantial reductions in the level of their credit card fees so that they would *not* surcharge credit card transactions.<sup>73</sup> In addition, many Australian merchants differentially surcharged – i.e., applied surcharges to American Express (and Diners Club if they accept that less commonly accepted brand) transactions but not to MasterCard or Visa credit card transactions (and not to debit cards). Merchants did this because of the higher merchant fees charged by American Express and Diners Club, and many customers use non-surcharged cards at merchants that surcharge.<sup>74</sup>

48. Professor Hausman states that I neglect to explain that under the terms of the Agreement, the amount of any surcharge on American Express transactions will have to equal the amount that the merchant surcharges MasterCard and Visa credit card transactions.<sup>75</sup> To the contrary, I devote Part 4.1 of my initial declaration to that issue. It is Professor Hausman who neglects to address the fact that the weighted average merchant fee for all credit card

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<sup>71</sup> Hausman Report, ¶172.

<sup>72</sup> Id.

<sup>73</sup> Merchants are also more likely to surcharge or *credibly threaten to surcharge* the more common surcharging becomes generally in the retail economy.

<sup>74</sup> Hausman Report, ¶174. American Express undertook efforts to curb differential surcharging and

<sup>75</sup> Hausman Report, ¶174.

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transactions in the United States exceeds the American Express fee in Australia, and the average difference between credit card and debit card fees in the United States substantially exceeds the difference between American Express and MasterCard/Visa fees in Australia. Moreover, most merchants in Australia that surcharge credit card transactions appear to apply the same surcharge to all brands.<sup>76</sup>

49. Professor Hausman contends that the willingness of merchants to surcharge credit card transactions in Australia is not representative of their likely willingness to surcharge credit card transactions in the United States because there is “greater competition in most retail sectors in the U.S. than in Australia.”<sup>77</sup> He concedes that a “limited” number of merchants will surcharge and receive an economic benefit from the settlement, but he assumes that these will be large-size merchants, and that “[m]erchants in more competitive sectors and especially small- and medium-size merchants are unlikely to surcharge.”<sup>78</sup>

50. I disagree that the competitiveness of merchant sectors makes it unlikely that a significant number of merchants will surcharge. In fact, in the New Zealand litigation, Professor Hausman agreed that there is “intense competition between merchants” (i.e., in New Zealand),<sup>79</sup> yet he argued that the evidence from Australia was “contrary” to an opposing

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<sup>76</sup> This can be seen from the 75% of American Express merchants that East & Partners reported applied surcharges in 2010 together with [REDACTED]

<sup>77</sup> Hausman Report, ¶176.

<sup>78</sup> Hausman Report, ¶119, 89. In citing Australian data, Professor Hausman focuses on the smaller share of transactions surcharged than merchants that surcharge, caused in part by the large merchants obtaining lower fees not so that they would not surcharge. When predicting the effects of elimination of no-surcharge rules in the United States, he inconsistently focuses on his prediction that a small number of merchants will surcharge, despite his contention that these will tend to be large merchants.

<sup>79</sup> Evidence in reply of Professor Jerry Hausman (redacted open version) in *Commerce Commission v. Cards NZ Limited, et al. and DSE (NZ) Limited, et al. v. Cards NZ Limited et al.*, 4 September 2009 (“Hausman New Zealand Brief of Evidence in Reply”), ¶17.6.

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expert’s claim that “merchants would be unlikely to surcharge in New Zealand.”<sup>80</sup> In Australia, some of the largest merchants were able to obtain significantly lower credit card merchant fees to keep them from surcharging credit cards. [REDACTED]

[REDACTED]<sup>81</sup> In any event, as I showed in my initial declaration, small- and medium-sized merchants, not just large merchants, have adopted surcharging in large numbers. In New Zealand, Professor Hausman noted evidence that “in New Zealand both travel agents and computer companies surcharged credit card transactions, even though it violated their agreements with acquirers” and that “[t]hese market actions refute the claim that only large merchants, with market power, will surcharge credit card transactions if permitted to do so.”<sup>82</sup>

51. In his report in MDL-1720, i.e., litigation against MasterCard and Visa in the United States, Individual Merchant Plaintiff expert Dr. Velturo states that “[REDACTED] [REDACTED].”<sup>83</sup> He relies on the experience in Australia in which “[REDACTED]”<sup>84</sup> Like me, Dr. Velturo relies on the level of American Express and Diners club fees in Australia and the fact that those high fees induce surcharging to support his opinions about MasterCard and Visa surcharge rules

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<sup>80</sup> Id., ¶6.22

<sup>81</sup> [REDACTED]

<sup>82</sup> Hausman New Zealand Brief of Evidence, pp. 15-16.

<sup>83</sup> Velturo MDL-1720 Report, ¶201.

<sup>84</sup> Velturo MDL-1720 Report, ¶204.

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in the United States context.<sup>85</sup> Dr. Velturo addressed and rejected claims by one of the experts for the defendants in that case that few merchants would surcharge because of the fear that they would lose customers to non-surcharging merchants – i.e., the same claim made here by Professor Hausman.<sup>86</sup>

#### **4.2.3. Surcharging is More Likely in the United States than in Australia or the U.K. at Current Levels of Merchant Fees**

52. Many merchants chose to surcharge American Express card transactions in Australia because the average American Express merchant fee was 2.51% in 2003 (even after “pre-emptive” reductions in 2002, discussed below). By 2005, the average American Express fee was still over 2.3% and surcharging accelerated. The average MasterCard and Visa merchant fee in Australia was less than 1.0% by 2005 (and trending lower), and merchants were less inclined to apply surcharges to those cards. In the United States, by contrast, merchant fees for all of the major brands on average exceed 2.3%. Thus, merchants here are more likely than in Australia to be interested in surcharging all of those brands.

53. Professor Hausman points to the United Kingdom where he says that surcharging is infrequent.<sup>87</sup> He fails to note that MasterCard and Visa interchange fees are far lower in the United Kingdom than in the United States, and the average merchant fee for those brands is about 1.4%.<sup>88</sup> Moreover, the U.K. Office of Fair Trading found that despite those lower fees,

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<sup>85</sup> Velturo MDL-1720 Report, ¶1204.

<sup>86</sup> Reply Report of Dr. Christopher A. Velturo, In Re: Payment Card Interchange Fee and Merchant Antitrust Litigation, June 22, 2010, ¶110.

<sup>87</sup> Hausman Report, ¶¶81-82.

<sup>88</sup> See, Frankel MDL-1720 Reply Declaration, ¶32.

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14% of businesses in the U.K. applied surcharges to credit cards, and 9% applied surcharges to charge cards.<sup>89</sup>

#### **4.3. Surcharging Permits Merchants to Recoup the Cost of Credit Card Payments Directly From Customers Who Use Credit Cards and Post Lower Shelf Prices**

54. In my initial declaration, I stated that a direct effect of surcharging (or, as Professor Stiglitz puts it, “pricing” of credit card transactions) is that merchants that surcharge credit card transactions recoup the cost of those transactions from customers who use credit cards rather than from all customers generally.<sup>90</sup> I do not believe that this issue is in dispute. For example, Professor Hausman has explained that “[e]vidence from Australia demonstrates that some merchants will levy surcharges for credit card use to recover the [merchant fees] when the ‘no surcharge’ rule is eliminated.”<sup>91</sup> By contrast, without surcharging, merchants “recover [the merchant fee] by increasing their prices to all consumers, whether or not the consumers are using credit cards.”<sup>92</sup> This is a central theme of Professor Stiglitz.<sup>93</sup>

55. In his discussion of “business stealing,” however, Professor Hausman ignores the fact that merchants surcharging credit card transactions will tend to have lower posted prices

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<sup>89</sup> United Kingdom Office of Fair Trading, “Payment Surcharges: Response to the Which? Super-Complaint, July 2012, ¶5.5. “Charge cards” consist of American Express and Diners Club, and East & Partners reports that only 10.1% of 505 surveyed merchants in the United Kingdom accepted American Express or Diners Club cards in 2009. East & Partners, “Australian and UK Credit Card Surcharging Perspectives: Custom Analysis for NERA Australia,” November 2009 (HOUSTON001120), Table 17. The East & Partners survey suggests that a significant percentage of merchants that accept American Express or Diners Club cards in the U.K. apply surcharges to those cards, but the percentage of merchants that accept charge cards is only roughly suggested by the East & Partners report, which found only 51 U.K. merchants that accepted American Express or Diners Club in addition to MasterCard and Visa, 19 of which (37.3%) applied surcharges. *Id.*, Table 20. (East & Partners states that this reported percentage is “for indicative purposes only” and not likely reliable as a specific percentage.)

<sup>90</sup> Frankel Declaration, ¶¶45-46.

<sup>91</sup> Hausman New Zealand Brief of Evidence, ¶5.2.

<sup>92</sup> Hausman New Zealand Brief of Evidence, ¶6.12.

<sup>93</sup> See, e.g., Stiglitz Declaration, ¶23 (with the NDP in place [REDACTED]

[REDACTED] ).

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than merchants that do not surcharge, thereby making additional sales and profits to customers who do not use credit cards (i.e., “business stealing” in the other direction).<sup>94</sup>

#### **4.4. Many Customers Will React to Credit Card Surcharges by Using Lower Cost Alternatives at Merchants that Surcharge, Reducing Costs and Prices**

##### **4.4.1. Narrow Relevant Markets Do Not Imply That Credit Card Surcharges Cannot Shift Transaction Volume to Debit Cards**

56. American Express, MasterCard, and Visa have all enforced anti-steering rules, including importantly no-surcharge rules, which have impeded competition between them at the point of sale. Professor Stiglitz, Dr. Velturo, Professor Hausman, and I all agree that most merchants that accept MasterCard, Visa, and American Express cards find it necessary to accept those cards despite supracompetitive levels of fees for all of those networks because of the loss of transaction volume – and thus profits – which would be incurred if the merchants stopped accepting any of those brands. Moreover, as I explained in Part 3.1, we are in agreement that from an economic perspective (because merchants have not been able to shift transactions even from one of those credit card networks to another), one can define separate relevant markets for each of those brands of credit cards.

57. The economic support for the existence of brand-specific relevant merchant credit card markets does *not* mean that differential surcharges, for example, on more costly American Express cards would not induce a significant number of consumers to choose instead to use a lower cost brand of credit card. The objectors, Professor Stiglitz, and Professor Hausman, in fact, all point to the continued prohibition of differential surcharges under the terms of the Agreement as having precisely that effect. The cumulative effects of the card

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<sup>94</sup> Frankel Declaration, ¶47.

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networks' prohibitions on price differentials (and other forms of interbrand steering) are the main reasons why one can define brand-specific relevant markets. Professor Stiglitz and Dr. Velturo emphasize that the relevant market would have been broader in a but-for world in which the anti-steering rules had not been in effect.<sup>95</sup>

58. Yet the National Retail Federation relies on the existence of separate relevant credit card and debit card antitrust markets (in the presence of anti-steering rules) to claim it is a “fallacy” to conclude that surcharges on credit cards will cause a relative shift of transaction volume to debit cards.<sup>96</sup> The Constantine Cannon Objectors likewise cite the existence of separate relevant markets for credit cards and debit cards to claim it is a “faulty premise” that the Agreement will allow merchants to steer transactions from credit cards to debit cards.<sup>97</sup>

59. These inferences cannot be drawn from the existence of separate relevant credit card and debit card markets.

60. Like Professor Stiglitz and Dr. Velturo, my analysis of the history of payment systems in the United States has led me to conclude that in a but-for world in which card payment networks had not operated with anticompetitive restraints, the relevant market would likely be broader than it is in the actual world today. That is not to say that removing the prohibition on credit card surcharging *today* will immediately create a broader relevant market. Indeed, even if widespread credit card surcharging under the settlement were to cause great

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<sup>95</sup> For example, in MDL-1720, Professor Stiglitz explained that [REDACTED]

[REDACTED] Stiglitz MDL-1720 Report, ¶169.

<sup>96</sup> NRF Statement of Objections, p. 8.

<sup>97</sup> CC Brief, p. 31.

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numbers of consumers to switch to debit, that still would not necessarily imply a broader relevant market.<sup>98</sup>

61. Today, merchants use blended or “bundled” pricing in which customers using high cost credit cards and low cost debit cards all pay the same retail price. Moreover, as Professor Stiglitz and Professor Hausman note, credit card issuers use some of their merchant fee revenue to offer rebates and other “rewards” (i.e., negative prices) to credit card users, so that consumers are provided with an incentive to use the more costly payment method. If a merchant “unbundles” these prices, the net price for credit card customers will increase and the net price for debit card customers (and cash customers) will decrease. Even in the unlikely scenario that no customer switched from using a credit card to using a debit card, basic economic principles imply that merchants will increase their sales to debit card and cash customers and reduce their sales to credit card customers.

62. Of course, almost all consumers who possess a credit card also possess a debit card and most use a debit card for at least some transactions, and, as Professor Stiglitz has explained, the proportion of transactions for which it will be optimal for cardholders to use their credit cards will tend to decline and the proportion for which it will be optimal to use their

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<sup>98</sup> Conventional relevant market definition methods can be confusing in this context because consumers often face no price or a negative price (due to rewards) and surcharges are often expressed in percentage terms. Converting to dollars simplifies the point. Suppose a \$100 purchase generates a reward worth \$1 to a consumer, so that the price to use a credit card is -\$1. If a merchant charges a \$2 surcharge for use of a credit card, the new price to the cardholder is +\$1, a change of +200% *in the price to the cardholder to use a credit card* – even though that surcharge is only 2% of the price of the items purchased from the merchant. The net price to the merchant has decreased by roughly 100% because the merchant fee is offset by the surcharge revenue. A 5% or 10% increase in the price of a credit card transaction to a cardholder (i.e., a conventional market definition threshold increase) would be generated by a surcharge of only 0.05% to 0.10% on the overall purchase amount. In other words, only if very small surcharges were sufficient to cause credit card networks to reduce their fees to the level of debit card fees would the two likely be in the same relevant market from the perspective of merchants.

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debit cards will tend to increase. This, too, is basic economics. This substitution in the face of surcharges does not have to be so great as to imply a single relevant antitrust market consisting of credit card and debit card network services together in order for surcharging to benefit merchants. With a credit card surcharge, each transaction that migrates to a debit card saves the merchant costs, and each transaction made using a credit card generates additional revenue to offset at least some of the extra cost associated with credit cards.

**4.4.2. Professors Stiglitz and Hausman Have Agreed that Credit Card Surcharges Shift Some Credit Card Transactions to Debit Cards**

63. Professor Stiglitz and Professor Hausman emphasize how differential surcharges on more costly credit cards (such as American Express cards in Australia) will tend to cause a shift in use towards lower cost credit cards. I agree. But by the same token, surcharges on all credit cards will cause some customers to switch to debit cards for some transactions. In fact, Professor Stiglitz and Professor Hausman have previously agreed with me that credit card surcharges drive transaction volume to non-surcharged cards, *including debit cards*. In his MDL-1720 reports concerning MasterCard and Visa anti-steering rules, Professor Stiglitz repeatedly explained that merchant restraints (including no-surcharge rules) prevented an efficient migration of some credit card transactions to debit cards.

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<sup>99</sup> Stiglitz MDL-1720 Report, ¶42.

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[REDACTED] ”100

- [REDACTED] ”101

- [REDACTED]

- [REDACTED]

- [REDACTED]

- [REDACTED]

- [REDACTED] ”102

- [REDACTED] ”103

- [REDACTED] ”104

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<sup>100</sup> Stiglitz MDL-1720 Report, ¶168.

<sup>101</sup> Stiglitz MDL-1720 Report, ¶173.

<sup>102</sup> Stiglitz MDL-1720 Report, ¶181 (citing Reserve Bank of Australia, Reform of Australia’s Payments System: Preliminary Conclusions of the 2007/08 Review 1-2 (Apr. 2008).

<sup>103</sup> Stiglitz MDL-1720 Report, ¶182 (citing Neelie Kroes, Eur. Comm’r for Competition Policy, Speech at the European Retail Round Table Conference: Europe’s Payment Systems after the MasterCard Decision (Jan 14, 2008)).

<sup>104</sup> Reply Report of Joseph Stiglitz, Ph.D., In Re: Payment Card Interchange Fee and Merchant Antitrust Litigation, June 22, 2010, p. 63.

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64. In his report in the American Express litigation, Professor Stiglitz writes:

- [REDACTED] <sup>105</sup>
- [REDACTED] <sup>106</sup>

65. In New Zealand, like here, Professor Hausman defined separate credit card and debit card markets.<sup>107</sup> Yet he also explained that credit card surcharges in various possible scenarios *would cause some credit card transaction volume to migrate to debit cards* (called “EFTPOS” cards in New Zealand).

- “The least cost acceptance vehicle for many merchants is EFTPOS. The use of EFTPOS will increase if surcharges are levied on credit card transactions. Also, I would expect the usage of credit cards with lower [merchant fees] to increase because surcharges on those cards would be lower than the surcharges on cards with higher [merchant fees].”<sup>108</sup>
- “[E]conomic analysis would typically find that merchants with market power would increase prices above the competitive level to all customers, not only credit card customers who could easily shift to a competing payment form, e.g., EFTPOS.”<sup>109</sup>
- “I consider the likely outcome if the [honor all cards] rule remains but the no surcharge and no discrimination rules are eliminated along with the [multilateral interchange fee]. I expect an increase in competition compared to the current situation because merchants will levy (higher) surcharges on credit cards with high [merchant fees] so long as merchant acquirers unbundle their [merchant fees]... Merchants will also attempt to steer consumers to the use of lower cost payment options such as EFTPOS or credit cards with lower [merchant fees].”<sup>110</sup>

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<sup>105</sup> Stiglitz Report, p. 19.

<sup>106</sup> Stiglitz Report, ¶29.

<sup>107</sup> Hausman New Zealand Brief of Evidence, ¶¶4.4-4.6, 4.12, 4.14.

<sup>108</sup> Hausman New Zealand Brief of Evidence, ¶5.2 (p. 17).

<sup>109</sup> Hausman New Zealand Brief of Evidence, pp. 36-37.

<sup>110</sup> Hausman New Zealand Brief of Evidence, ¶6.39.

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- “[I] have discussed how the agreement among the banks to enforce the Visa and MasterCard rules leads to anti-competitive restrictions, e.g. the no surcharge rule, on possible merchant strategies to cause consumers to use lower cost payment options, e.g. EFTPOS cards. These Visa and MasterCard rules lead to higher effective MSFs paid by merchants... I find that in the counterfactuals if the agreement to enforce some or all of the rules is eliminated, the expected outcome is a reduction in the MSFs paid by merchants in the acquiring market, which is a pro-competitive outcome.”<sup>111</sup>
- “With lower [interchange fees], more consumers would instead use EFTPOS or cash so merchants’ costs would be lower.”<sup>112</sup>
- “In his further discussion of surcharging as free-riding... Prof. Wright neglects to take into account that many consumers carry more than one credit card which they can switch to or use their EFTPOS card.”<sup>113</sup>
- “Prof. Wright states that without the no surcharge rule and HAC rule interchange fees might become negative... This outcome has not been observed in countries where the no surcharge rule has been eliminated. Further, the cost of using credit cards would increase, especially for transactors, i.e. credit card users who do not have a credit balance. Many of these credit card users would switch to EFTPOS.”<sup>114</sup>
- “If merchants have the ability to steer or surcharge individual issuers, they will establish steering policy or set surcharges to offset an attempt by an issuer to charge higher interchange. As elsewhere in his brief, Prof. Wright fails to take into account that many people carry more than one credit card and almost all credit card users also have an EFTPOS card. Customers who do not want to pay the surcharge will switch to another credit card or use their EFTPOS card.”<sup>115</sup>
- “Merchants would establish steering policies and/or set a high surcharge fee on the given issuers’ transactions which would cause credit card users to switch to another credit card or to use EFTPOS.”<sup>116</sup>

66. In short, these experts and I agree both that there are narrow relevant markets in the actual world in which surcharging has been prohibited, and that when merchants are able to surcharge credit cards, at least some credit card transaction volume will migrate to debit cards, benefitting merchants. Posted (debit card and cash) prices will tend to be lower

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<sup>111</sup> Hausman New Zealand Brief of Evidence, ¶7.1.

<sup>112</sup> Hausman New Zealand Brief of Evidence in Reply, ¶4.3.

<sup>113</sup> Hausman New Zealand Brief of Evidence in Reply, ¶16.16.

<sup>114</sup> Hausman New Zealand Brief of Evidence in Reply, ¶19.6.

<sup>115</sup> Hausman New Zealand Brief of Evidence in Reply, ¶19.7.

<sup>116</sup> Hausman New Zealand Brief of Evidence in Reply, ¶19.8.

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and credit card prices (with the surcharge) higher, but the relative shift of some transaction volume from credit to debit will mean lower average costs overall (and thus greater sales), even apart from any reduction in the level of credit card merchant fee rates.

**4.4.3. A Recent One-Year Change in Credit and Debit Card Volume in Australia Does Not Disprove The Usefulness of Surcharges at Steering to Debit**

67. Professor Hausman claims here that surcharging of credit cards has not “led to a significant shift to debit cards in Australia.”<sup>117</sup> His view is not shared by the Reserve Bank of Australia or by the Australia Payment Clearing Association (APCA), as I cited in my initial declaration.<sup>118</sup> Professor Hausman discounts my citation to these observers as “selective quotes” but he presents no contradictory views by other Australian observers.<sup>119</sup> He suggests that an empirical test of whether credit card surcharging has led to a significant shift to debit card usage is a comparison of the “growth rate of the dollar amount of credit-card usage” with that of “debit-card usage in Australia over the same period.”<sup>120</sup> He reports that credit card dollar charge volume increased by 10.2% between December 2012 and December 2013, and that growth rate was the highest in the past six years. Further, he reports that the growth rate of credit card charge volume exceeded the increase in debit card charge volume during the same twelve month period.<sup>121</sup>

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<sup>117</sup> Hausman Report, ¶178.

<sup>118</sup> Frankel Declaration, ¶56. The RBA is the country’s central bank. The APCA describes itself as “the self-regulatory body for Australia’s payments industry. APCA has 90 members including Australia’s leading financial institutions, major retailers and other principal payments service providers.” <http://www.apca.com.au/about-apca>

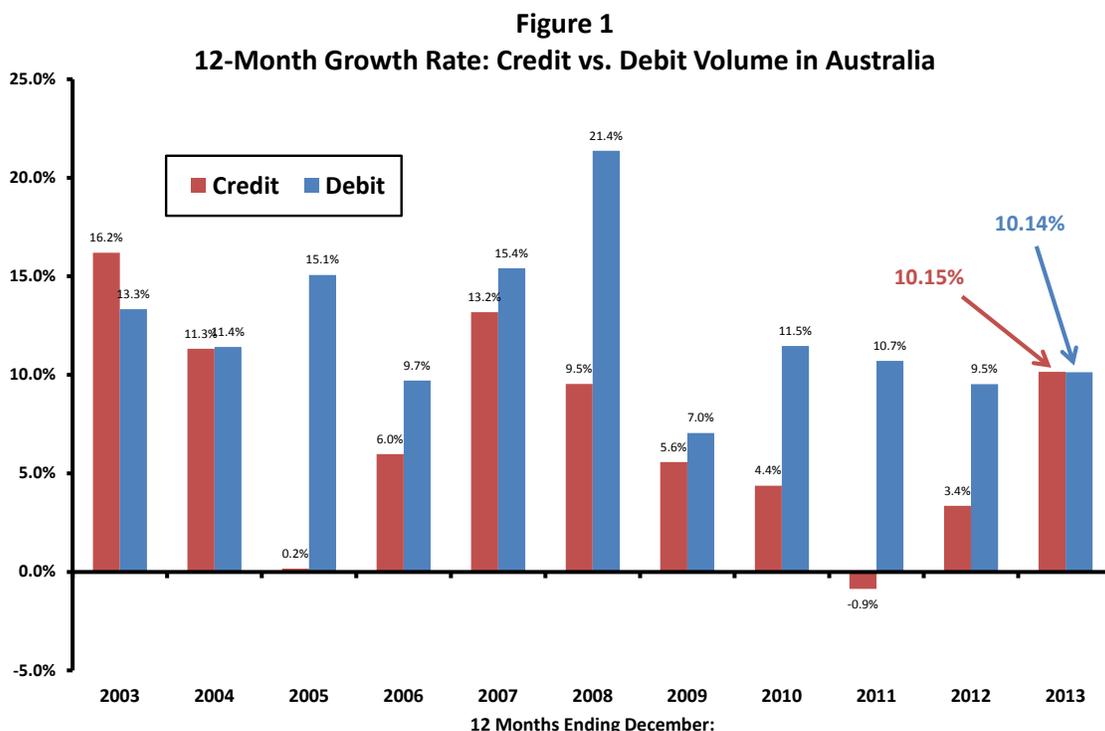
<sup>119</sup> Hausman Report, ¶178.

<sup>120</sup> Id.

<sup>121</sup> Id.

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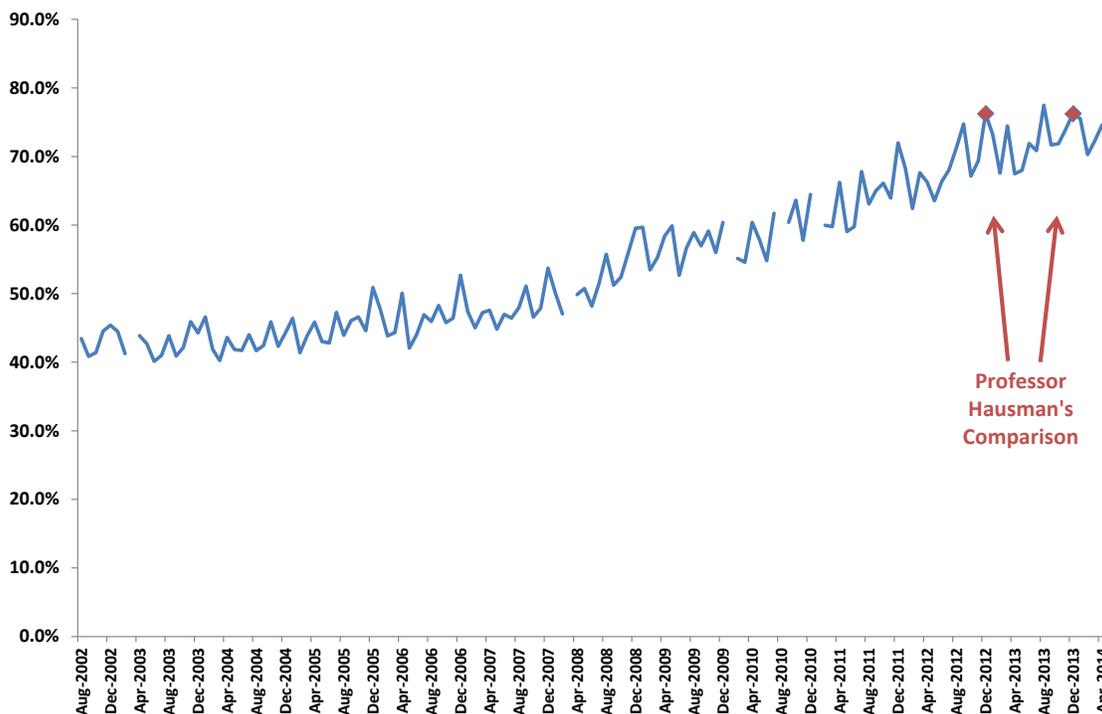
68. I am familiar with the data relied on by Professor Hausman for this analysis, which are published by the RBA. I have extended his analysis in two ways. First, rather than focus on a single 12-month period ending in December 2013 – a decade after the elimination of no-surcharge rules in Australia – I have replicated his computation for each period ending in December of each of the available previous years as well. I show the result in Figure 1. Second, instead of focusing only on year-over-year changes for each December, I have computed the aggregate dollar charge volume on debit cards in Australia as a percentage of the charge volume on credit cards in each month since both series have been available beginning in August 2002. I show the result of this analysis in Figure 2.



Sources: <http://www.rba.gov.au/statistics/tables/xls/c01hist.xls?accessed=2014-06-23-15-38-54> and <http://www.rba.gov.au/statistics/tables/xls/c05hist.xls?accessed=2014-06-23-15-38-54>.

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**Figure 2**  
**Ratio of Debit to Credit Card Charge Volume in Australia 2002-2014**



69. Figures 1 and 2 paint a picture quite different from that suggested by Professor Hausman’s cherry-picking of December 2012 and December 2013 as his dates for comparing the growth of debit card and credit card usage. It is true, as Professor Hausman reports, that credit card usage grew by 10.2% in the year ending December 2013, and that this exceeded the growth rate of debit card usage during that same period. Closer examination, however, shows that the difference in these growth rates was only 0.018% during 2013, and that this 12-month period was aberrational. As Professor Hausman notes, credit card usage grew at the fastest rate in six years in 2013. Figure 1 shows that, aside from the one-fiftieth of one percent faster credit card growth than debit card growth in 2013, in every other year ending each previous December since 2003 (the year credit card surcharging began), debit card growth exceeded credit card growth in Australia. Figure 2 shows the cumulative effect of this differential

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growth.<sup>122</sup> Aggregate debit card spending was about 40-45% of credit card spending throughout most of the period August 2002-2005, but since then this ratio has increased sharply. The very slightly faster growth rate of credit card usage in the brief, recent period examined by Professor Hausman saw this ratio decline by 0.01%, but that left the ratio at 76.3% – far above the level prevailing in 2003. Moreover, there is no sign that the upward trend has ceased.

#### **4.5. The Threat to Networks of Lost Transaction Volume From Credit Card Surcharges Will Generate a Previously Suppressed Competitive Constraint on the Level of Credit Card Merchant Fees**

##### **4.5.1. Networks Lose More Transactions as Merchant Fees Increase if Merchants Can Surcharge Than If Merchants Cannot Surcharge**

70. As I have already explained, at the current level of credit card fees merchants benefit from surcharging credit cards even without consideration of any change to the level of merchant fees resulting from surcharging. Merchants that surcharge recoup credit card costs specifically from customers who use credit cards and so can charge lower prices to cash and debit card customers, which increases sales to those customers. Moreover, some consumers will alter their payment choices for at least some of their transactions. I showed in my initial declaration (and neither Professor Stiglitz nor Professor Hausman has disputed) that transactions migrating from credit cards to debit cards will save merchants approximately 1.57% of the transaction amount. Cost reductions also lead to price reductions, leading to increased overall sales.

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<sup>122</sup> Figure 2 uses the same sources as Figure 1 and the same as those used by Professor Hausman. Gaps in the trend line in Figure 2 indicate months in which the RBA reports “series breaks” due to changes in reporting.

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71. Credit card networks have long imposed and fought to preserve no-surcharge rules for obvious reasons. If card networks are more costly to merchants than the alternatives, and merchants can price the more costly networks at a higher level, then customers will have an increased economic incentive to choose an alternative, non-surcharged payment method than if merchants cannot surcharge the more costly cards. This increases the elasticity of demand faced by a card network with respect to merchant fees, which as a result will have an economic incentive to set lower merchant fees than if merchants cannot surcharge. No-surcharge rules, on the other hand, leave merchants with an all-or-nothing choice whether to accept credit card brands, reduces the elasticity of demand faced by each network, and results in higher merchant fees.

72. I first described this analysis of the effects of no-surcharge rules on the level of merchant fees in the mid-1990s.<sup>123</sup> Since then, many others have reached the same conclusion. Professor Stiglitz agrees that anti-steering rules (including no-surcharge rules) reduce the elasticity of demand facing card networks and results in higher merchant fees.<sup>124</sup> He agrees that when merchants surcharge, the [REDACTED]

[REDACTED] ”<sup>125</sup>

73. In New Zealand, Professor Hausman agreed that no-surcharge rules lead to higher merchant fees:

I have discussed how the agreement among the banks to enforce the Visa and MasterCard rules leads to anti-competitive restrictions, e.g. the no surcharge rule, on possible merchant strategies to cause consumers to

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<sup>123</sup> See, e.g., Alan S. Frankel, Monopoly and Competition in the Supply and Exchange of Money, 66 Antitrust Law Journal 313 (1998), at pp. 343-47.

<sup>124</sup> Stiglitz Report, ¶134; Stiglitz MDL-1720 Report, ¶¶10(l), 41.

<sup>125</sup> Stiglitz MDL-1720 Report, ¶42.

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use lower cost payment options, e.g. EFTPOS cards. These Visa and MasterCard rules lead to higher effective MSFs [merchant fees] paid by merchants. The MSFs are a variable cost for merchants and are passed on in higher prices to all consumers, whether they use credit cards or another form of payment. I find that in the counterfactuals if the agreement to enforce some or all of the rules is eliminated, the expected outcome is a reduction in the MSFs paid by merchants in the acquiring market, which is a procompetitive outcome.<sup>126</sup>

74. The elasticity of demand with respect to merchant fees would be enhanced the most, putting the most downward pressure on credit card merchant fees, if merchants had complete flexibility to accept or reject, encourage or discourage, and surcharge or discount whichever cards they wished. But the effect even of uniform credit card surcharges is the same directionally, if not in magnitude.

**4.5.2. Surcharging Intensifies Constraints on Merchant Fees Relative to the Status Quo Even if Uniform Across Brands**

75. If merchants could differentially surcharge in the United States, this would tend to generate a relatively greater competitive constraint on American Express than on MasterCard or Visa (or Discover Card) because of American Express's relatively higher merchant fee. But the use of differential surcharges would unlikely be as widespread as in Australia. While there is variation across merchants, in the United States I estimate that the average American Express transaction migrating to MasterCard or Visa today would save a merchant

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<sup>126</sup> Hausman New Zealand Brief of Evidence, ¶7.1.

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approximately 17 basis points.<sup>127</sup> In Australia, in 2004-05, the difference was approximately *140 basis points*.<sup>128</sup>

76. When merchant fees for different brands of credit cards are relatively close to one another, fewer merchants will differentially surcharge even if they have the contractual ability to do so. Even with merchants that differentially surcharge in Australia, it is common to see merchants charge the same surcharge for American Express and Diners Club transactions, despite likely differences in the cost of each brand. It is also common for merchants in Australia to parity surcharge all credit cards at the same level. As the National Retail Association of Australia has observed, in filings with the RBA:

For retailers who elect to surcharge credit card purchases, simplicity and efficiency are primary considerations in setting such fees. . . . Surcharges must be easy for consumers to identify and calculate and easy for retail sales staff to administer. Often a single surcharge for all credit cards will be preferred by retailers due to its simplicity of operation and the ability of the retailer to look at their total costs related to such transactions in establishing an appropriate fee.<sup>129</sup>

77. Even if differential surcharging in the United States hypothetically eliminated differences between merchant fees for different credit card brands, surcharging would continue to exert a constraint on network merchant fees, even if merchants thereafter used only uniform surcharges. The credit card network industry is highly concentrated, and each network would bear a significant share of the lost transaction volume resulting from merchant

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<sup>127</sup> Frankel Declaration, Figure 3. 

<sup>128</sup> <http://www.rba.gov.au/statistics/tables/xls/c03hist.xls>

<sup>129</sup> National Retail Association Submission to Reserve Bank of Australia: Review of Card Surcharging, July 25, 2011. <http://www.rba.gov.au/payments-system/reforms/submissions-card-surcharging/nra-card-surcharging.pdf>

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surcharging.<sup>130</sup> The competitive pressure on a network increasing its merchant fees would not be as great as would exist if some merchants singled out that network for differential surcharging, but there will be a more effective competitive constraint than exists in the current marketplace in which networks face no effective constraint when they raise fees and consumers are provided no incentive to avoid using credit cards in response to those higher fees.

**4.5.3. Professor Hausman is Incorrect in His Claim that Surcharging Has Not Caused a Reduction in American Express's Merchant Fees in Australia**

78. Professor Hausman never identifies any anticompetitive conduct that he believes American Express has engaged in or any remedies that would erode its significant market power. He criticizes the Agreement for leaving intact American Express's no-differential surcharge policy with respect to alternative credit cards, but that is puzzling, because Professor Hausman's analysis (incorrectly) suggests that that American Express policy has no significant anticompetitive effects. He contends that even in Australia, where American Express's merchant fee was 140 basis points above those of MasterCard and Visa, differential surcharging had *no effect* on American Express's merchant fees. But if the ability to differentially surcharge had no effect at reducing even American Express's fees when they were 140 basis points above those of other credit card networks, that ability cannot logically have a significant competitive effect in the United States where the major card networks' fees are much closer and he contends merchants are less likely to surcharge.

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<sup>130</sup> That is not to say that some merchants will not finely distinguish different surcharges for different brands or that some major merchants would not negotiate favored no-surcharge agreements with particular brands in exchange for lower fees if differential surcharging were an available option. Differential surcharging would continue to be a valuable competitive merchant tool even if all brands' merchant fees started out the same.

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79. Professor Hausman goes further, suggesting that the relevant measure of American Express’s merchant fees has actually *increased* in Australia despite the ability to surcharge and differentially surcharge. But American Express’s average merchant fee has decreased by 78 basis points since March 2003, compared to 61 basis points for the interchange-regulated MasterCard and Visa. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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80. In other words, the effective American Express merchant fee in Australia has declined by between 83-113 basis points, compared to a decline of 61 basis points for MasterCard and Visa, notwithstanding the lack of direct regulatory intervention with respect to American Express’s rates. [REDACTED]

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<sup>131</sup> Velturo Report, ¶204, citing Malhotra Deposition Exhibit 352.

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[REDACTED], and there is no need for me to repeat all of that evidence here.<sup>132</sup>

81. Professor Hausman’s claim that surcharging had no effect on American Express’s rates, and in fact that “AMEX has grown relatively *more expensive* than VMC since Australia began allowing surcharging,” is based on his computation of the *ratio* of American Express’s average merchant fee to that of MasterCard and Visa.<sup>133</sup> He contends that is the economically relevant measure of price for purposes of evaluating the effects of surcharging. But it is not.

82. Professor Hausman asserts that “the *decreases in AMEX’s fees* have been due to the lower regulated interchange rates of VMC and merchants’ ability to refuse to accept AMEX.”<sup>134</sup> But his use of the declining *level* of American Express’s fees to evaluate the claimed effectiveness of merchants’ ability to refuse to accept American Express cards and the *ratio* to MasterCard and Visa fees to evaluate the effectiveness of surcharging is arbitrary.

83. I agree that reductions in MasterCard and Visa merchant fees *contributed* to the decline in American Express merchant fees, but *so did the elimination of no-surcharge rules*. [REDACTED]

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<sup>132</sup> Velturo Report, ¶¶205-228, 235-249.

<sup>133</sup> Hausman Report, ¶168 (emphasis added).

<sup>134</sup> Id. (emphasis added).

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84. If American Express’s no-surcharge policy had been left in place in 2003, it would have faced less pressure to reduce its merchant fees. Professor Hausman, however, suggests that the RBA agrees with his conclusion that surcharging has played *no* role at constraining merchant fees.<sup>136</sup> In 2009, the then-Head of Payment Policy at the RBA agreed with me.

I think there are two things driving this [continued reduction in American Express merchant fees] (1) the fact that the spread widened after interchange fees fell meant that Amex had to lower its fees over time to remain competitive and to increase acceptance and (2) surcharging has hit Amex much harder than [sic] Visa and MasterCard which has in some cases resulting [sic] in it having to lower its [merchant service fees] to avoid surcharging.<sup>137</sup>

85. In its 2011 review of card surcharging, the RBA affirmed its view that no-surcharge rules “limited the ability of merchants to put downward pressure on their merchant service fees and interchange fees by threatening to charge the customer for using a credit or scheme debit card.”<sup>138</sup>

86. Professor Hausman cites data concerning the (minor) growth in the combined *market share* of American Express and Diners Club (relative to MasterCard and Visa) based on transaction dollar volume as evidence that “surcharging has not constrained AMEX and Diners *merchant fees*.”<sup>139</sup> That is a non sequitur. In fact, despite the issuance of “companion”

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<sup>135</sup> [Redacted]

<sup>136</sup> Hausman Report, ¶168.

<sup>137</sup> Rebuttal Report of Alan S. Frankel, Ph.D., In Re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, June 22, 2010, citing email from Michelle Bullock to Alan Frankel, May 31, 2009.

<sup>138</sup> RBA June 2011 Consultation Document, p. 2.

<sup>139</sup> Hausman Report, ¶171. At least part of that reported increase results from a change in the RBA’s reporting methodology, as Visa debit transactions are now being excluded from that network’s reported market share. <http://www.rba.gov.au/statistics/tables/exp-note/c2-note-120510.html>

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American Express cards by Australian banks and despite American Express's much higher merchant fees and the ability to use those fees to continue funding reward programs, the "death spiral" that MasterCard and Visa warned about in Australia did not materialize. Professor Hausman contends that a slight uptick in the combined share of American Express and Diners Club shows that surcharges have failed to constrain those networks. In fact, it shows the opposite. Banks that issue MasterCard and Visa credit cards lost about 45 basis points of merchant (interchange) fee revenue due to RBA regulation. The major banks began issuing companion American Express cards and encouraged the use of those cards with enhanced rewards for use of American Express instead of the MasterCard or Visa credit card linked to the same account. Yet American Express has lost over 83-113 basis points of merchant fee revenue and has been unable to induce a significant migration to usage of its cards.

#### **4.6. The Agreement Benefits Merchants With Respect to All Current Credit Card Usage, Not Only American Express Card Usage**

87. In my initial declaration, I estimated roughly the benefits to merchants for each one percent of charge volume that becomes subject to credit card surcharges in the United States. The Target Objectors state that my computation should be disregarded because I do not separate the value from surcharging American Express from the value of surcharging MasterCard and Visa.<sup>140</sup> But I have explained in my declarations in MDL-1720,<sup>141</sup> and again in this case,<sup>142</sup> that American Express's NDP prevented most merchants from applying surcharges

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<sup>140</sup> Omnibus Objections to the American Express Class Action Settlement of Absent Putative Rule 23(B)(2) Class Members Target Corporation, et al., June 6, 2014, p. 26.

<sup>141</sup> Frankel MDL-1720 Declaration, Part 4.6.2 and Frankel MDL-1720 Reply Declaration, Part 4.4.2.

<sup>142</sup> Frankel Declaration, Part 3.6 and Part 2 above.

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to MasterCard and Visa credit card transactions permitted under the relief obtained in MDL-1720. As I explained in MDL-1720, American Express's policy significantly reduced the value that merchants otherwise would have obtained from the relief in that case. The relief proposed in the Agreement will free merchants now to surcharge all credit card brands. As an economic matter, the benefits to merchants from the settlement thus include the benefits not only from the ability to surcharge American Express card transactions, but also the ability to surcharge all brands by merchants that accept American Express cards.

## 5. STATE RESTRICTIONS

88. In my initial declaration I noted arguments that state statutes restricting credit card surcharges eliminate any value from elimination of network no-surcharge rules.<sup>143</sup> Professor Hausman repeats this argument and computes the percentage of U.S. commerce in ten states he says prohibit surcharging.<sup>144</sup> He notes as I did that a federal court has determined that New York's statute is unconstitutional, and he states how his computed percentage of commerce in no-surcharge states would change if "that court's judgment is reversed," but he does not compute how it will change if instead other courts decide similarly to that in the New York case. In addition to legal challenges, I also explained that state restrictions may be subjected to competitive challenges as merchants that can choose their location may consider surcharge rights in addition to other factors.

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<sup>143</sup> Frankel Declaration, ¶4.2.

<sup>144</sup> Hausman Report, ¶52. Professor Hausman notes that "some merchants have significantly more than 35% of their business in the states which prohibit surcharging." Hausman Report, ¶53. If any state prohibits surcharging that will be true, because there are single-location merchants in every state. But that also means that there are many merchants with *none* of their business in no-surcharge states.

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89. There is no dispute in this case that the relevant geographic market is the United States, and I noted that “Visa and MasterCard, for example, do not set separate interchange fees in separate states” so that competitive pressure resulting from surcharging will have a nationwide effect.<sup>145</sup> Professor Hausman criticizes this on the grounds that “how Visa and MasterCard price says nothing about the effect of the settlement’s limited surcharging on AMEX’s merchant fees.”<sup>146</sup> But as I have explained, the settlement frees merchants that accept American Express to apply surcharges also to MasterCard and Visa credit card transactions.<sup>147</sup>

## 6. CONCLUSION

90. One of the factors that has made surcharging a relatively effective strategy for merchants in Australia was the endorsement of surcharging as a legitimate and pro-consumer business strategy by regulators and merchants alike. In the United States, the National Retail Federation has stated that surcharging “runs 180 degrees” from the goal of litigation to reduce credit card merchant fees and prices paid by consumers.<sup>148</sup> That is exactly wrong, and it is unfortunate. The ability to surcharge is a tool that merchants can use to reduce the very substantial market power exercised by card networks in the United States. Demonizing surcharging as anti-consumer and ineffective will not help merchants to use surcharging successfully to generate its potential procompetitive effects.

91. Professor Stiglitz, Dr. Velturo, and I agree about the fundamental economic issues and forces that lead me to conclude that the ability to surcharge, even if restricted to

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<sup>145</sup> Frankel Declaration, ¶173.

<sup>146</sup> Hausman Report, ¶157.

<sup>147</sup> Professor Hausman states that “AMEX does not have nationwide merchant fee tables as do Visa and MasterCard.” Id. [REDACTED].

<sup>148</sup> <https://nrf.com/media/press-releases/nrf-says-merchants-unlikely-surcharge-credit-card-use>

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uniform surcharges, will have beneficial effects for merchants and their customers. I agree that more complete reforms of the card networks would be even more beneficial, but that is not an option currently available, and I am not able to opine on the likelihood that rejection of this Agreement would be followed by more complete, market-wide relief. Notwithstanding Professor Hausman's criticisms of my analysis, he and I also agree on most of the fundamental economic issues, including the substantial market power exercised by all of the major U.S. credit card networks. Where I differ from both him and Professor Stiglitz is my conclusion that the ability to apply uniform credit card surcharges is beneficial (even though it is easy to imagine even more beneficial market arrangements). Professors Stiglitz and Hausman, on the other hand, take an extreme position – that the ability to surcharge all credit card transaction has *no* value to U.S. merchants. I do not believe that position is supported by economic analysis or the evidence. Moreover, Professor Hausman does not even offer a coherent prescription for relief that American Express on its own *could* provide that would significantly reduce its market power.

July 4, 2014



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Alan S. Frankel