

SURCHARGING

It's a prisoner's dilemma at best



OC&C Strategy Consultants

With retailer margins razor thin, the opportunity of returning 1-5% of card purchase transactions to the bottom-line through POS surcharging structures is very appealing

Keri Aivazis
Mathew Segal
David Lallemand

The fees associated with credit and debit card transactions have been under increasing pressure from the merchant community in recent years. In addition to disputing the interchange levels themselves, involved merchants are aligning to legally challenge the explicit Visa and Mastercard rules that prohibit merchants from attempting to recoup these costs from card-paying customers via surcharging.¹ With retailer margins razor thin, the opportunity of returning 1-5% of card purchase transactions to the bottom-line through point-of-sale surcharging structures is, not surprisingly, very appealing.

The natural question becomes, what will merchants actually do if they are able to place surcharges on card transactions? At present, this appears to be shaping up as a classic prisoner's dilemma: with consumer reaction to surcharging a big unknown, it is difficult to construct an effective strategy without knowing what the competition is planning. Few merchants are willing to experiment with a potential sales decline due to adverse consumer reaction. The right strategy seems to be either 'wait and follow' or 'proceed collectively.'

The purpose of this study is to look down the road and assess the potential impact of POS fee recovery schemes on consumer behavior and the effectiveness that such programs might have in enhancing retailer margins. The results are based on a survey of over 1000 consumers and have implications for both the payments industry as well as merchants developing forward looking strategies. With 71% of customers claiming that surcharging would impact their long-term purchasing behavior, the answer may not be as clear-cut as some merchants would have hoped.

Keri Aivazis, Mathew Segal and David Lallemand are with OC&C Strategy Consultants, an international strategy consulting firm with offices in the US, Europe, Middle East and Asia. Contact the authors at keri.aivazis@occstrategy.com, mathew.segal@occstrategy.com, and david.lallemand@occstrategy.com.



It is important to keep in mind that payment-type selection is highly contextual. It will be heavily influenced by the individual financial situation and the efficiency that card payment brings to the purchaser at any point in time, the sector and competitive landscape in which a purchase is being made, and the size of the transaction. This study focused on the clothing retail and grocery sectors and intends to be an initial assessment and generate directional indicators. It does not explore all the particular nuances that could affect POS payment behavior.

THE STUDY

The study is based on a survey of over 1000 card-carrying consumers with the population split fairly equally across gender. The majority of those interviewed commonly purchase food and clothing and shop in household-named department stores, mega-stores, grocery and retail chains. To establish context for the switching opportunity across payment type it is important to note that 60% of the sample typically carry less than \$50 in cash at any given time and almost half rarely or never carry their check books.

Two structures for merchants to recoup or avoid fees from card paying consumers were explored in the study: 1) a surcharge penalty and 2) incentives in the form of discounts or coupons to persuade consumers away from card payment. The general themes emerging from the study suggest that surcharging or other fee recovery schemes will not have the positive margin impact merchants are seeking. The study indicates that consumer behavior is very sensitive to POS dynamics which attempt to influence payment selection and pricing schemes aimed at helping merchants recover or avoid discount fees. Moreover, we found that consumers are strongly opposed to surcharging and the net effect of such programs would be value destruction for merchants.

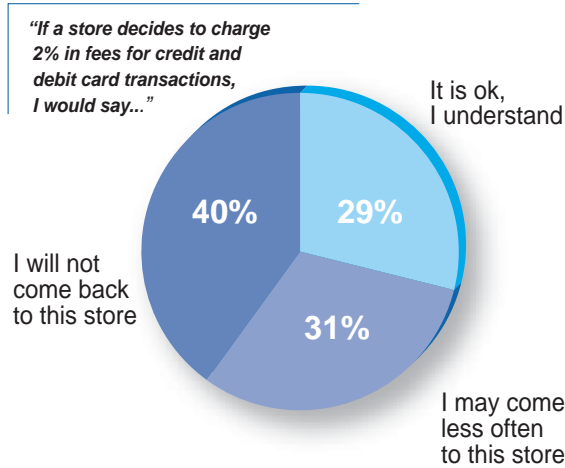
Surcharging or other fee recovery schemes will not have the positive margin impact merchants are seeking...

Consumers will not accept overt surcharges on card purchases

Consumer Reaction

The majority of respondents is aware that merchants pay a fee for credit or debit card transactions but is strongly opposed to explicitly carrying any of the burden themselves as a way of keeping retail costs down. In fact, over 71% of the respondents claim surcharging card transactions would impact their long term purchasing behavior.

Customer Opinion



Source: OC&C Consumer Survey (February 2006)

The interviewed consumers were specifically questioned on their reaction to surcharging in the context of a \$70 transaction (an average retail basket) in which they planned to use card payment but had alternative payment options available at the point of sale.

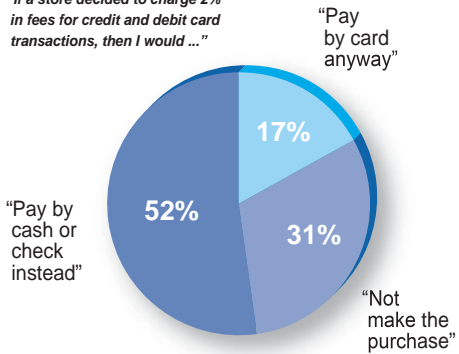
The study suggests that the impact on merchant sales would be significant — 31% of the respondents said they would cancel their purchase if charged a 2% fee for debit and credit card transactions. In the case where the interviewees were asked a similar question in the context of not having alternative payment types on-hand, the indication remains grim for surcharge-anxious merchants; 59% said they would simply leave the store with a 2% surcharge.

Consumers will vote with their pocketbook:
59% of the study respondents said they would leave the store if they had to pay an extra 2%



Customer Reaction:

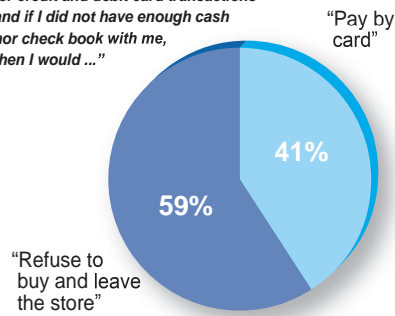
"If a store decided to charge 2% in fees for credit and debit card transactions, then I would ..."



Source: OC&C Consumer Survey (February 2006)

Customer Reaction:

"If a store decided to charge 2% in fees for credit and debit card transactions and if I did not have enough cash nor check book with me, then I would ..."



Source: OC&C Consumer Survey (February 2006)

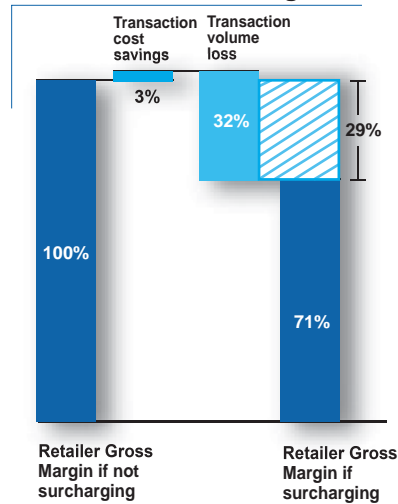
Impact on Merchants

The negative impact of surcharging on merchant sales volume is significant; the study suggests that merchants who charge transaction fees of 2% would lose a large fraction of sales coming from their card paying customers.² In addition, the analysis indicates that the savings made on transaction costs would not sufficiently compensate for the volume impact. In fact, the impact of surcharging at a 2% level would reduce retailer margin by nearly 30%.

The major driver in margin loss is the decrease in sales volume. One significant caveat to the model is the assumption that consumers have alternatives in sourcing their products and services, i.e. consumers whose reaction to surcharging would be to discontinue the transaction are likely assuming that they can find an alternative merchant who doesn't charge transaction fees. This analysis computes the economic impact in the presence of choice; if choice were to disappear, it is almost certain that consumers would not change their spending habits because of surcharges.

Incentive structures such as discounts and coupons intended to dissuade consumers from card payment offer another potential fee remedy mechanism for merchants.

The Impact of Surcharging on Retailer Gross Margin



Source: OC&C Consumer Survey (February 2006)

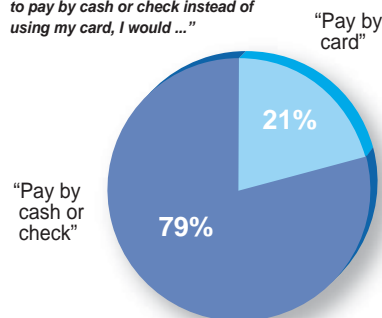
Given consumer reaction, merchants would experience significant margin erosion with either surcharging or discounting

When asked if a POS discount would influence payment behavior on our test case transaction, an overwhelming majority of the consumers interviewed responded favorably, suggesting the convenience value of debit and credit cards is relatively low. It's noteworthy that the switch is driven more by the presence of a discount than by the actual level, indicating minimal consumer sensitivity to discount values. While discounting appears heavily influential, it only brings margin value to the transaction when the aggregate discount level (i.e., discount on all purchases) is less than the fees merchants pay for card acceptance and implementation at the terminal does not introduce significant costs. It also influences only those consumers who have the financial capacity to avoid card payment and have sufficient cash or a checkbook on hand to complete the transaction.

Coupon-ing provides an interesting alternative to discounting. The survey suggests that issuing coupons for later use compels consumers to switch away from card payment. Coupons have the added advantage that a large fraction of POS-issued coupons tend to promote customer retention but ultimately go un-redeemed. Coupons have the same disadvantage as discounts however — they are only effective for a fraction of consumers with a particular financial profile and payment capability.

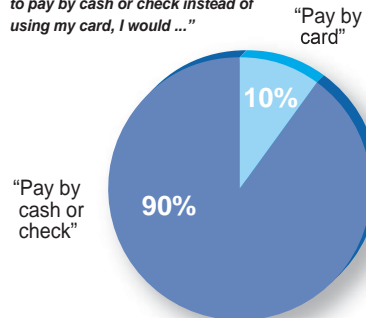
Customer Reaction:

"If a store offered me a 2% coupon to pay by cash or check instead of using my card, I would ..."



Source: OC&C Consumer Survey (February 2006)

"If a store offered me a 2% discount to pay by cash or check instead of using my card, I would ..."



Source: OC&C Consumer Survey (February 2006)

Discounts and coupons are a powerful POS strategy, but will not provide positive margin impact for retailers, however...certain sectors are ripe for surcharging



Incentive schemes seem an interesting alternative to the volume and margin loss created by surcharging. The study indicates that customers are easily influenced by incentives and would even purchase more by check or cash to redeem nominal discounts or coupons. However, our analysis indicates that the global impact on margins would be negative, as merchants would provide incentives on all non-card transactions and not just the additional share that was created by having the incentive program in place.

The results of the study indicate that POS fee-recovery schemes would generally destroy value for merchants. However, there are sectors which are better suited to implementing surcharge schemes without driving significant loss in sales. Specifically, these include sectors with transaction characteristics fitting the following profile:

- 1) High consumer switching costs / no alternatives — “They have no choice”
- 2) High ratio of business transactions — “Their company’s paying anyway”
- 3) Large average transaction — “They don’t have the cash”
- 4) Low sector margin — “Discount fees dramatically reduce our profitability”
- 5) Perceived added value of credit card purchase — “They’ll use their credit card for the insurance”

The airline industry, for example, could rationally move to enact a surcharge policy to enhance margins. There are relatively high switching costs as the availability of routes may be limited and fares on the same route can vary significantly from airline to airline; many passengers are traveling on business and the average transaction tends to be high enough to make payment by cash or check unrealistic; an extra 1% to the bottom line would have a significant impact in an industry suffering from extreme margin pressure; and finally, customers often seek the added value that card transactions bring in the form of travel benefits such as insurance and double airline points.

Surcharging or other fee recovery schemes will not have the positive margin impact merchants are seeking...

CONCLUSION

Australia provides a glimpse into the future of what might happen in the U.S. if surcharging were allowed. In January of 2003, the Reserve Bank of Australia imposed a mandatory lifting of the “no surcharge rule.” A survey of 2,200 businesses in January of the following year indicated that almost half of Australia’s merchants said they were considering applying surcharges to their credit card transactions over the next year. The reality, however, has been very different. Based on a random sample of Australian retailers, merchants have not yet begun passing along transaction fees to customers. This is not to say that transaction fees couldn’t become commonplace in the future. Consumers pay millions of dollars in ATM transaction fees per year, with many, despite their protestations, unwilling to walk across the street to use a bank-owned machine. Will consumers put their money where their mouth is, or will surcharging follow suit and become an accepted ‘cost of doing business?’

In general, a lifting of the surcharge rule will allow merchants more flexibility and creativity in developing POS pricing strategies which attempt to influence consumer payment behavior. For many retail sectors, the promise of such schemes requires that there be few switching alternatives for consumers or that the sector players share a common surcharge policy to mitigate the volume effect. The dilemma arising from both not knowing your competitor’s strategy and price setting being anti-competitive suggests that the best strategy for merchants is to do nothing - or proceed with great caution as the payments industry redefines itself.



NOTES

1 The primary targets of the 'no-surcharge' litigation are Visa and MasterCard. American Express does not have a prohibition on surcharging, but rather imposes an 'equal-treatment' provision preventing merchants from discriminating their surcharging policy between AMEX and its competitors. Discover Financial Services recently lifted its ban on surcharges in favor of an 'equal-treatment' provision and was subsequently dropped as a defendant in the no-surcharge lawsuits filed by merchants.

2 To assess the financial impact to merchants of surcharging, two different consumer groups need to be considered separately: 1) consumers that could switch to cash or check payment as a reaction to surcharging and 2) those that could not. In both groups we assume a 52:48 distribution to cash/check or card payment as preferred payment option. The analysis assumes a 50% gross margin for retailers, a conservative 1.5% average fee paid by merchants for credit and debit card transactions and is based on the statistics of our consumer sample:

- 65% of the respondents would typically have cash or check payment as an alternative to card payment for a \$70 transaction; 35% of the respondents would not typically have a switching alternative
- 52% of the respondents use cash and checks as their primary payment option, while the remaining 48% turn to credit (19%) and debit cards (29%)

Offices

New York
711 Third Avenue
Suite 1806
New York, NY 10017

San Francisco
101 California Street
Suite 1050
San Francisco, CA 94111

+1 212 803 7280
contact@occstrategy-usa.com



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