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Utility proposals to include credit card processing fees in rates do not the run risk of forcing low-income households to subsidize high cost premium cards.

NOTE TO READERS

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SUBSIDIZING "ELITE" CREDIT CARDS NOT SUBSTANTIAL PROBLEM IN UTILITY "FEE FREE" PROPOSALS

On balance, it appears that socializing the fees of credit and/or debit card payments, as well as ACH payments, of utility bills would not particularly harm low-income households. While credit card payments of utility bills is not *recommended* for low-income consumers –it has the impact of borrowing money at high interest rates to pay for ongoing monthly bills for essential services if card balances are not retired each month—concerns that have been expressed that higher-income customers use what are called "elite" cards to make purchases at higher costs do not present a reason to avoid socializing these costs.

Elite cards provide perquisites such as airline miles and/or "cash back." These perquisites, of course, are not "free," but rather are paid for by fees imposed on cardholders and merchants accepting such cards. Accordingly, the concern expressed is that, by socializing the fees associated with the use of credit and/or debit cards, lower income customers, who do *not* qualify for the elite cards, are being asked to subsidize the higher fees to, in essence, allow higher income customers purchase items such as premium air fares, hotel stays and the like.

For the following reasons, those concerns are not found to be sufficiently persuasive to outweigh the benefits to low-income households from being able to pay utility bills with a credit and/or debit card on a fee free basis.

Reason #1:

Too many moving parts exist in credit card merchant fees to justify isolating elite card fees for consideration to the exclusion of all other factors.

The component of a credit card fee associated with elite cards is relatively small. The fee a merchant must pay to their Merchant Service Provider ("MSP") is affected by a "discount rate" applied to each transaction. The Discount Rate is calculated as follows:

Discount Rate = interchange fee + assessment fee

The biggest portion of the Discount Rate is the interchange fee, which comprises between 70% and 90% of the total fee paid. The interchange fee is affected by the type of card (i.e., rewards card vs. regular card). It is, however, *also* affected by factors such as the type of card being used (e.g., MasterCard vs. Visa vs. Discover vs. American Express) and how the payment is processed. Master Card, Visa and Discover impose relatively comparable interchange fees, while American Express is somewhat more expensive.[1]

The other portion of the Discount Rate is the assessment fee. The assessment fee, which is smaller than the interchange rate, varies by card network (e.g., MasterCard vs. Visa vs. Discover). In addition, some networks charge higher fees for credit card than for debit card usage. Discover tends to have lower assessment fees. Fees also differ, for example, between whether a payment is made on-line, whether a fee is made by a "swiped card," or whether a payment is made through a mobile device.

Above and beyond the Discount Rate (comprised of the two components discussed immediately above), each MSP will charge a fee for the services they provide. Pricing differs. For example, MSPs can use a "tiered" pricing scheme, which bases the cost on whether a charge is a "qualified" transaction (i.e., debit cards, non-reward cards) or a "non-qualified" transaction (i.e., corporate cards, rewards cards). However, other MSPs use what is called "blended pricing." In the latter instance, the charge is a flat rate for all transactions. Whether a customer pays with a credit card, a debit card, or a rewards card, the charge will be identical.

The MSP industry is an intensely competitive industry and, as a result, good shopping by a utility should have the effect of minimizing such fees (and thus minimizing any "subsidies" between users of rewards cards and regular cards).

The lesson to be drawn from this discussion is that there are simply too many moving parts to the fees to be socialized through any utility proposal to justify isolating the costs of rewards cards as a reason to critique the proposal. There is no reason to isolate "rewards" cards from "regular" cards, but then to ignore the higher costs of mobile phone transactions versus on-line transactions. There is no reason to isolate rewards card transactions while ignoring the difference in costs between MasterCard, Visa and Discover. There is no reason to isolate the costs of reward card transactions while ignoring the higher cost of credit card transactions relative to debit card transactions.

[1] Another factor affecting the size of the fee is the type of merchant at issue. Since, for our purposes here, all transactions are those with a utility this factor is set aside for this discussion.

Reason #2:

The danger of potential "subsidies" is reduced as the penetration of rewards cards moves toward 100%.

As the penetration of rewards cards amongst credit card users moves closer to 100%, the concern is reduced that non-elite card users will be called upon to subsidize elite card users if card fees are socialized in utility rates. Even though not universal, use of rewards programs by credit card users is becoming higher and higher. The concern about the added cost of rewards cards assumes that there are two distinct populations: one which uses rewards cards and thus imposes higher costs and the other which does ***not*** use the rewards cards but nonetheless subsidizes those who do. As the penetration of rewards cards becomes closer and closer to 100%, however, the distinction between rewards users and non-rewards users becomes less and less.

According to the TSYS[2] 2018 U.S. Consumer Payment Study,[3] "loyalty reward programs continue to be the top influencer when consumers are choosing between multiple credit cards. Seventy-nine percent of survey respondents indicated rewards are a key reason [why] they use one credit card over another. Cash-back continues to be consumers' most frequently redeemed reward."[4] TSYS reports that "rewards continue to be the number one factor for why consumers use one credit card over another. This was true again this year, with 79% claiming it influenced their choice, followed by the finance charge/interest rate."[5] It reports that "cash-back continues to be consumers' most loved type of reward. Eighty percent of consumers in this year's survey with a rewards program on their card have redeemed for cash."[6]

The percentage of consumers using rewards credit cards has constantly increased in recent years.[7] According to the annual TSYS consumer payment study, in 2016, 69% of consumers said their most preferred credit card had a reward program associated with it.[8] In 2017, that percentage had increased to 75%.[9] By 2018, it had increased to 79%.[10]

There is some legitimacy to the notion that higher income consumers use rewards cards more than lower income consumers. The difference, however, is perhaps not as high as might be expected. The difference is ***certainly*** not that "all" non-low-income consumers use

[2] TSYS was formerly known as Total System Services. Headquartered in Columbus (GA), it is primarily a payment-processing firm.

[3] TSYS has published a "consumer payment study" annually since 2011.

[4] TSYS 2018 Consumer Payment Study, at 7.

[5] TSYS 2018, at 23.

[6] TSYS 2018, at 24.

[7] It is perhaps important to note the subtle differences in data reported year-over-year by TSYS. For example, the 2016 study asked whether the preferred credit card had a rewards program associated with it. In contrast, the 2017 asked not merely whether their preferred card had a rewards program, but whether the rewards "influenced their choice" of credit cards. In 2018, the question was not merely whether the rewards influenced their choice, but rather whether the rewards component was "the number one factor" why consumers *use* one credit card over another. Moreover, while the 2017 study appears to inquire about which cards consumers *have*, the 2018 study inquires about which cards consumers *use*. Given that most consumers have more than one credit card, those questions are somewhat different. Despite these differences, the story of increased importance that consumers attach to the presence of a rewards program seems evident.

[8] TSYS 2016, at 20.

[9] TSYS 2017, at 8.

[10] TSYS 2018, at 23.

rewards cards while "all" low-income consumers do not. When asked what credit card feature consumers found most attractive, the identification of "rewards" as most important[11] unquestionably varied by income.[12]

Rewards as Top Feature of Credit Card Choice
By Annual Income

<25,000	$25 - <$50,000	$50 - <$75,000	$75 - <$100,000	$100 - <$150,000	$150,000 or more
55%	62%	71%	80%	80%	78%

Card security was also a critical feature used in choosing which card to own and/or use.

Several observations flow from the data presented above. First, the difference between higher income and lower income consumers' use of rewards credit cards is smaller than might be expected (and is certainly not an "all or nothing" proposition). And the difference is even smaller than indicated in the table above. The table indicates, by income, when rewards are the *top* (i.e., most important) selection factor. It is, however, *not* the overall penetration of rewards as a credit card feature. Simply because the finance charge / interest rate may be a *more* important selection factor to a lower income consumer does not mean that the consumer does not use a rewards card.

In any event, the use of rewards cards has become ubiquitous, even if not quite universal. Penetration is approaching closer to 100% each year. The penetration of rewards cards increased from 69% to 79% simply in the two years from 2016 to 2018.

Reason #3:

Not all rewards costs are recouped through the merchant fees socialized in utility "fee free" proposals.

One of the concerns about socializing credit card fees amongst all utility consumers is that the increased costs of merchant fees (discussed above) for rewards cards would be imposed on low-income consumers even though those cards are used primarily by higher income consumers. As noted immediately above, that concern is not entirely without a basis.

However, while there is a merchant fee cost difference imposed by some (though, as discussed above, not all) MSPs, the increased cost of rewards cards falls primarily on the card user, not on the merchant through the merchant fee or discount rate which would be captured by a utility proposal. Increased consumer costs are found in two different ways (and represent reasons why the use of rewards cards is not necessarily a "good deal" from the consumer's perspective). First, rewards cards generally have annual fees –sometimes as high as $200 to $300—not charged on non-rewards cards. Moreover, rewards cards more often than not carry higher interest rates (finance charges).

The potentially higher merchant costs of rewards cards are offset by these consumer fees. As a result, these costs would *not* be a part of the costs captured through a utility "fee free" proposal.

[11] Other features included, but were not limited to, factors such as the finance charge/interest rate, the card brand (e.g., Visa, MasterCard, etc.), customer service, payment options, and the ability to use the card through a mobile device application.
[12] TSYS 2018, at 23.

Reason #4:

Rewards do not extend to debit cards, the use of which substantially outweighs credit card usage.

Utility proposals to socialize the fees associated with both credit card payments and debit card payments will most likely affect far more debit card transactions than it will credit card transactions. Data published by the Federal Reserve board ("FRB") reports that far more debit card transactions occur than credit card transactions. And debit transactions are growing nearly as fast as credit card transactions as well. According to the FRB:

> Total card payments (both credit and debit), which represented 7.3 percent of core noncash payments by value and 75.3 percent by number in 2018, grew at a rate of 8.9 percent per year by number between 2015 and 2018—up from the 6.8 percent yearly rate of increase from 2012 to 2015. Debit cards, including both prepaid and non-prepaid, were used almost twice as often as credit cards in 2018, but the value of credit card payments exceeded the value of debit card payments by almost 30 percent.[13]

The FRB continued:

> The value of *remote* general-purpose card payments reached $3.29 trillion in 2018, nearly equal to the value of *in-person* general-purpose card payments (emphasis in original), driven in part by growing e-commerce card payments <u>*and the use of cards for recurring bill payments*</u>. (emphasis added).[14]

[13] The Federal Reserve Payments Study: 2019, at 1.
[14] Id., at 2.

This FRB data is consistent with other published data. For example, according to the 2018 TSYS U.S. Consumer Payment Study:

> Depending on which source you read, the credit card market may continue to see significant growth throughout 2019, or continued tightening of credit may occur. This year's study found that, when given a choice, <u>*consumers overwhelmingly prefer to use their debit cards to pay*</u>. Although we've seen this consistently with our U.S. study throughout the years –the percentage who selected debit this year was the highest ever.[15]

TSYS continued to report:

> Although debit has consistently led as the most preferred payment type over the years of our study (all but one of the last six years), this year's percentage reached an unprecedented high. The difference between these who selected debit and those who selected credit as their most preferred payment type was also the widest variance we've seen. Cash was up slightly this year, too.
>
> * * *
>
> There may be other factors at play, too. <u>*Previous TSYS studies found that many consumers like to use debit cards as a way to pay for everyday purchases*</u>, as a budgeting tool, or as a way to avoid paying finance charges on their credit cards. Additionally, millennials are generally known as 'debt adverse' and 2019 will usher them in as the largest living

[15] TSYS 2018, at 8.

> generation – surpassing the baby boomers.[16]

(emphasis added). According to the 2018 TSYS consumer payment study:

> Even when taking a closer look at findings by age range and income, results showed a stronger preference for debit than we've seen before. Overwhelmingly, this year's findings showed debit as a favorite across all age groups, compared to last year where it was a favorite for all age groups except those 65 and older.[17]

Preferred Payment Type by Age Range

Most preferred payment type	18 - 24	25 - 34	35 - 44	45 - 54	55 – 64	65+
Debit card	59%	58%	51%	56%	48%	51%
Credit card	21%	23%	24%	21%	29%	32%
Cash	15%	14%	13%	17%	14%	11%

For purposes of this discussion, the prevalence of debit card transactions is significant in several respects. First, the elite cards, which provide "rewards" to incentivize consumer selection decisions, are limited to credit cards. Utility Fee Free proposals, however, generally cover both debit and credit cards. By numbers of transactions, the use of debit cards far exceeds the use of credit cards, even if credit card use is more common in value terms. And the use of both is growing at roughly the same rates.

Moreover, debit cards are preferred as the payment mechanism of choice for smaller, routine periodic purchases and bill payments. In contrast, credit card usage is directed toward higher value, non-recurring purchases. It is, in other words, more likely that routine monthly utility bill payments would be made using debit rather than credit cards. It is for this reason that credit cards exceed debit cards in value terms even though not in numbers. Accordingly, the issue of high cost elite credit card use being subsidized through a utility's "fee free" proposal is of lesser concern.

[16] TSYS 2018, at 40.

[17] TSYS 2018, at 41.

Conclusion

The following observations are based on the data and discussion presented above:

1) Utility "fee free" proposals cover both credit and debit card transactions. The "elite" cards, which use rewards programs to incentivize consumer selection, are a subset only of credit cards.

2) Debit card usage far exceeds credit card usage in terms of numbers of transactions, even though credit card usage is greater in dollar value terms. One reason debit card usage is lower in dollar value terms is that debit cards are the payment option of choice for lower value, routine periodic payments such as monthly utility bills.

3) Within credit cards, as the penetration of rewards card use approaches 100%, the issue of non-rewards cardholders subsidizing rewards cardholders declines. As of 2018, the penetration of rewards cards reached 80%, a substantial annual percentage increase over 2016.

4) While rewards cards impose higher fees on merchants as part of the Discount

Rate charged per transaction, not all rewards cards charge merchants a higher rate for the MSP fee. Indeed, some MSPs charge a "blended rate," which treats rewards and non-rewards transactions the same. The MSP industry is intensely competitive. A utility should be able to contract with a blended rate network through good shopping.

5) The higher costs of providing rewards cards is not recovered exclusively through merchant fees. Those costs can alternatively be recovered through annual "membership fees" and/or higher interest rates / finance charges. This cost recovery is not captured by, or reflected in, a utility's "fee free" proposal. To the extent that cost recovery occurs through consumer fees, the merchant fee difference between elite and non-elite credit cards is lessened.

Based on the above, while the issue of elite credit cards is not a non-existent concern, on balance, the benefits of extending the "fee free" proposal to all card transactions seem to justify approval of utility Fee Free proposals.

For more information on utility Fee Free proposals, contact:

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