HELLER EHRMAN WHITE & McAULIFFE
ATTORNEYS
A PARTNERSHIP OF PROFESSIONAL CORPORATIONS

333 BUSH STREET
SAN FRANCISCO
CALIFORNIA 94104-2878
FACSIMILE: (415) 772-6268
TELEPHONE: (415) 772-6000

M. LAURENCE POPOFSKY
(415) 772-6310

ANCHORAGE
LOS ANGELES
PALO ALTO
PORTLAND
13057-0062
TACOMA

May 13, 1993

David Balto
Federal Trade Commission
6th & Pennsylvania Avenue
Washington, D.C. 20580

Dear Mr. Balto:

We want to address two matters with you in advance of our meeting next Tuesday:

1. Is there reason to believe that the general purpose charge card market is behaving non-competitively such that a single large entrant could be expected to have a material impact on the market?

2. What is wrong with the District Court's decision and why should the Federal Trade Commission care enough to get involved?

A brief discussion of each follows.

1. It would be surprising if the charge card business was not competitive. Structurally it is among the most competitive businesses imaginable. As has been much discussed, there are 6,000 VISA issuers overall. The top ten issuers account for approximately 50% of volume and, with the exception of the two major proprietary systems that already are successfully in the market, VISA membership remains open, thus permitting essentially unrestricted new entry. In fact, there has been a significant amount of new entry recently, although virtually all of that entry involves programs with cross-marketing devices -- a fact which suggests that the profit potential is perceived to be collateral to entry into the card business itself. (See AT&T-long distance; GM-cars, General Electric-various products.) We enclose three of the recent economic studies which underscore the point. Board of Governors of the Federal Reserve System, "The Profitability of Credit Card Operations of Depository Institutions" (August 1990); Canner & Luckett, "Developments in the Pricing of Credit Card Services", Federal Reserve Bulletin, September 1992; and Raskovich and Froeb, "Has Competition Failed in the Credit Card Market?", Department of Justice, June 1992.

P-0680

Structure should be definitive unless there is some evidence which suggests why a structurally competitive market does not work as such structure predicts. Three evidentiary candidates have been identified. They are (a) the "stickiness" of credit card finance charges as contrasted with prime and other interest rates and the "high" profits enjoyed by issuers; (b) the entry of AT&T; and (c) the Ausubel thesis predicated on consumed irrationality. Each warrants brief comment.

a. Leaving aside the unaddressed (except for Ausubel) problem of how a near "atomistic" market structure could fail to operate competitively, the arguments concerning "stickiness" and "high" profits do not survive scrutiny. It is true that for much of the late 1980's and until recently, the finance charge component of card pricing remained fairly stable for standard cards offered by the largest VISA/MasterCard issuers (as well, of course, as Discover). But that scarcely demonstrates an absence of competition given: (a) a period of substantially expanding demand; (b) the acknowledged problem of adverse selection of credit risks associated with interest rate competition; (c) the fact that experiments by large banks with lower rates proved unprofitable; (d) the fact that large banks expanded credit by lowering standards thereby attracting customers who are only marginally profitable; (e) the existence of significant service and amenity competition which is not affected by the adverse selection problem noted above; (f) the existence of at least some level of transaction costs associated with consumer switching; and (g) the fact that many banks have charged lower interest rates while applying stricter credit granting criteria. Put otherwise, "stickiness" appears to be characteristic of how this market functions rather than an indicator of market failure.

As for "high" profits, it suffices to note that the concept is without economic significance. The issue is whether the market is producing economic rents over a significant period of time, taking into account, of course, the risk-adjusted cost of capital. Leaving Ausubel aside again (for the moment), there is no evidence demonstrating that returns in the market are super-competitive. Indeed, Sears tried to introduce that argument into the trial without any empirical data to support it, only to have the evidence ruled inadmissible because of the absence of any pretrial study or disclosure.

b. The AT&T episode proves nothing. Sears' expert originally suggested the contrary, based upon "evidence" -- drawn from newspapers and the like -- that AT&T's entry "caused" lower prices. However, again, Sears did no study (or at least none it has admitted to) that attempted to validate its

contention. VISA did. That study, by Professor Richard Schmalensee, demonstrated that AT&T's entry "did not have significant effects on the prices consumers paid or credit card usage either in the form of annual fees or finance charges." When the fact of Dr. Schmalensee's study became known to Sears, its expert simply dropped all reference to AT&T as support for any of his economic opinions. We enclose Dr. Schmalensee's study, dated October 10, 1992.

c. We are left, then, with Ausubel and his theory of consumer irrationality. There are two fatal problems with it (in addition to the fact that an economic theory that turns upon irrationality is economically suspect to begin with): First, the work has been shown to be fundamentally flawed (see, in addition to the Department of Justice paper cited above, a memorandum from The Brattle Group entitled "Competition in the Market for Credit Cards" (enclosed); Second, if Ausubel is right, the "solution" has nothing to do with admitting Sears. If consumers don't care about high interest rates because they expect to pay off their balances, then the existence (or not) of Sears as a VISA issuer is a matter of no competitive significance.

2. There are two reasons why the Federal Trade Commission should participate in the Tenth Circuit Appeal. The first has to do with preservation of competition in the payment systems industry and the second has to do with the application of Section 1 of the Sherman Act to joint ventures generally.

a. As we read Judge Benson's decision, any joint venture rule is subject to challenge under the rule of reason under unstructured standards derived, essentially, from Chicago Board of Trade. This includes, although it is not limited to, rules regarding membership in the joint venture, not only at formation but thereafter. The result of that approach, in this case, is to compel VISA to admit Sears and American Express and, presumably, anyone else who might come along hereafter. So far as VISA (and, we assume, MasterCard) are concerned, the net effect will be the elimination of meaningful intersystem competition in the general purpose charge card industry. Judge Benson, himself, recognized that the result of the decision would likely be to diminish such competition, although he concluded that the magnitude of the harm was insufficiently great to condemn the arrangement as a matter of law under either Section 1 or Section 7 of the Clayton Act -- a conclusion that he reached by crediting Sears' stated "intention" to remain a vigorous competitor through Discover.

We believe that, from an enforcement perspective, those kinds of self-serving assurances cannot be seriously credited. In contrast to the several thousand VISA and MasterCard member-issuers, there are only four (or five, if one includes Diners Club) card systems. That is a market which is structurally suspect, to say the least. (Its current HHI is well above 3,000). Yet maintaining intersystem competition is exceedingly important. That competition involves such matters as the creation of clearing and authorization systems (plus associated hardware and software), new product development and related forms of competition that can only take place at the system -- as opposed to the member -- level. In addition, as evidence at trial demonstrated, competition in merchant discount rates is very much affected by the vigor of intersystem competition. That is so because of the impact which the VISA and MasterCard interchange rates have upon merchant discount rates and the consequent competitive interplay between those rates and the merchant discount rates set by the proprietary systems.

This competition would be substantially threatened by a rule which required VISA and MasterCard to be "universal" organizations. A world in which VISA (with Sears as a member) competes with Sears' Discover card is a world in which competitive incentives have fundamentally changed. The kind of intersystem competition which currently exists unquestionably would be undermined by Sears "post-acquisition" dual loyalties and the resulting incentives to coordinate, lessen or altogether abandon its current rivalry with VISA and MasterCard. See Areeda, 5 Treatise, ¶ 1203, at 320 (in the case of a partial acquisition "the acquiring firm's market decisions might be affected not only by their impact on its own operations but also by their impact on its investment . . . . in its competitor"). Had the merchant side of the business been sufficiently evaluated, the harm to competition would have been seen to be severe.

The implications for competition in the general purpose charge card business extend beyond those already noted. You are doubtless familiar with the history of duality between VISA and MasterCard as well as the substantial controversy surrounding the competitive consequences of that phenomenon. At a minimum, we think it fair to say that the result of duality has been a very substantial diminution of competition between the MasterCard and VISA joint ventures. Within the past two years, there has been a modest movement towards separation of the two systems with the consequent potential of increased future competition between them. However, were Judge Benson's decision ultimately affirmed, it is unlikely that this trend towards separation would continue. After all, if MasterCard and VISA cannot keep out major proprietary competitors such as Sears or American Express, there

is little reason for them to be interested in any other form of separation. The more likely outcome, we suggest, is that over time, system competition will be eliminated entirely.

Finally, we submit that the consequence of affirmance will be a substantial erosion of competition throughout the payment systems industry, including ATM and POS networks, both national and regional. Absent government intervention to prevent over-inclusiveness, the risk of adopting exclusionary membership rules that are subject to after-the-fact "veto" by a jury which is also authorized to impose treble damages is likely to deter any substantial effort to maintain membership limitations or exclusivity.

b. While we hope to elaborate on the payment system competition issues when we meet, we readily note that VISA does not seek your involvement for altruistic reasons. Rather, VISA's concerns have to do with what it perceives as an unfair imposition on its ability to operate competitively. Those are concerns which, we suggest, coincide with what we believe ought to be policy concerns of the Commission.

VISA has elected to remain open generally because of the existence of positive network externalities. Sears, however, imposes costs on VISA that are different from those imposed on the venture by other new entrants. Put otherwise, VISA believes that Sears' entry into the venture will unfairly advantage Sears at the expense of VISA's existing members.

Viewed ex ante, a rule which permits someone not merely to sit on the sidelines while others incur the expenses and take the risks of creating a new product or service, but actually to compete against them and, then, demand to be admitted to their venture does not, in our view, constitute sound economic or antitrust policy. Such a rule will, without question, have a deleterious effect upon the incentives to create what otherwise would be efficiency-enhancing joint ventures.

The threat to competition in this context does not come from exclusion but from potential over-inclusiveness. Certainly that is true short of a situation in which the excluded parties cannot compete fairly with the venture absent access to some unique property which the venture controls -- i.e., a "bottleneck monopoly" or "essential facility." Assuming that there is the potential for intersystem competition, and value in having such competition, antitrust policy should always seek to insure that adequate "venture level" competition is maintained -- an outcome that can be assured only if ventures are permitted to exclude those who are capable of competing independently or by forming

new joint ventures. That is, of course, the position reflected in the Justice Department's International Guidelines. It is a view that is shared, as well, by every economist and significant antitrust commentator who has written on the issue.

What is likely to emerge from the Tenth Circuit in this case is an opinion that will establish a regime of law governing joint venture formation and membership issues hereafter. That is a regime in which, we believe, the Federal Trade Commission and other federal agencies have a compelling stake.

We look forward to seeing you Tuesday. With me and my partner, Steve Bomse, who were lead trial counsel for VISA, will be Professor Schmalensee, Bennett Katz (VISA International's General Counsel) and Paul Allen (VISA USA's General Counsel).

Yours sincerely,

M. Laurence Popofsky