

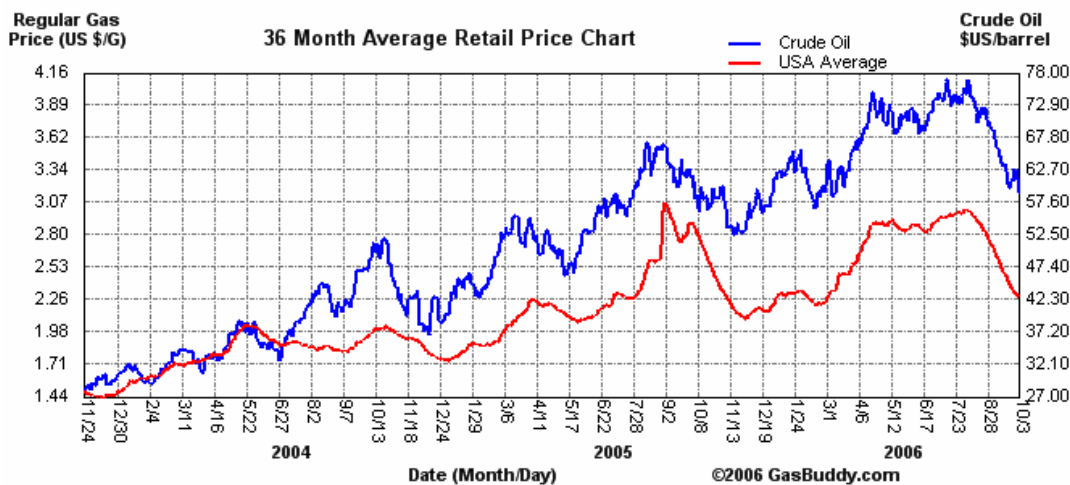
# Navigator

## Gas Price Volatility Ripples Through Payments Markets

By Joel Van Arsdale and Sahar Kamali

Precipitous increases in the price of gas in 2005 and much of 2006 contributed to slowing retail sales and heated political debates in the United States. In the payments world, this price volatility impacted the manner in which consumers paid for gas and dramatically altered the economic flows generated by these payments. From the beginning of 2004 to September 2005, the average U.S. retail price of gas more than doubled, much of which was sustained through 2006 before prices turned down again recently. Over this same time period, the volume of gallons purchased was remarkably stable. This combination of price volatility and inelastic demand results in huge fluctuations in card spend. For example, a price increase from \$2.00 to \$3.00 sustained over an entire year would result in \$80-\$100 billion in incremental annual card volume, increasing the revenue of issuers, acquirers, and network providers while increasing the expenses of the petroleum retailer. This article examines these economic impacts and discusses the card marketing implications of volatile gas prices.

Figure 1—U.S. Retail Gas & Crude Oil Price Trends



### Retailers, Acquirers, the Cost of Acceptance, and Anger over Interchange

The acquiring market in petroleum is unique in that over two thirds of retail outlets are branded with a major fuel brand meaning that they also generally process transactions through their branding partner (such as Exxon). Major fuel companies therefore effectively act as acquirers by determining the price charged to the retailer for processing card payments. Although not a single fuel company appears on a

list of top U.S. acquirers, the top ten fuel companies control acceptance and processing of an estimated \$150 billion in annual card volume, or about 70% of the total acquiring market in the sector.

When gas prices doubled over the short period between the beginning of 2005 and summer of 2006, profits for these fuel companies acting as acquirers grew significantly (as much as 80% in a discount-rate environment). On the flip side, retailers and marketers who helped fund this growth reacted by making card acceptance costs a major focus and topic of discussion. The reason, for petroleum retailers, is that gasoline yields are thin with largely fixed gross margins of only 5¢ to 10¢ per gallon according to *OPIS* (a benchmark which remains fairly consistent regardless of fuel price). As shown in *Figure 2* (on Page 2), if the price of gas doubles the costs of card acceptance increase in-parallel resulting in a drastic shift in profitability.

This profit dynamic explains why petroleum retailers are some of the most aggressive merchants in pursuing legal and political action against the card associations (although interchange is only one component of card acceptance costs, it has become the most visible). The National Association of Convenience Stores (NACS) and the National Association of Truck Stop Operators (NATSO) are both members of the Merchant Payments Coalition, a coalition of retailer industry associations which is actively exploring alternatives in court, on Capital Hill, and in the market to reduce the impact of card acceptance costs.

Rising card acceptance costs result in fuel retailers being aggressive in pursuing rate reductions from their acquirers. This hyper-sensitivity to card acceptance costs can be both an opportunity and a challenge for acquirers serving the segment. It can mean opportunity for the aggressive sales rep working the segment with an attractive price and targeted pitch, but it can also mean an increased need for retention-

based price discounts (which creates margin pressure when prices once again decline as they are currently). Branding companies providing processing services responded to increases in the price of gas over the past several years with rebates on processing fees and reductions in processing prices.

Retailers also get creative in exploring other means to control card acceptance costs when gas prices are high. During the 70's and 80's two-tier pricing (one quoted price for cash or proprietary cards and

(Continued on Page 2)

(Health Care and Payments Continued from Page 1)

one quoted price for credit cards) was prevalent until competitive pressure eventually lead to its decline. Now however, it appears that this practice could be returning if even on a limited scale. Other fuel retailers have chosen to only accept proprietary or debit cards, although this practice is similarly limited. Finally, when gas prices are high, card acceptance costs also become an even more important factor for selecting a branding partner. This means that not only are the processing prices offered by the fuel partner relevant, but so too is the appeal of the proprietary, co-brand, and fleet payment programs offered through the brand. This is because branded cards are often priced at heavy discounts to third-party cards (even as low as 0%).

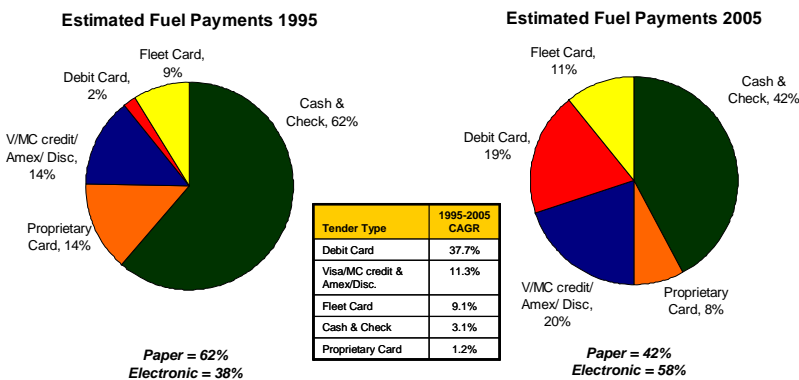
Figure 2: Hypothetical Fuel Retailer Economics

Gas Price	\$1.50	\$3.00
Gallons Purchased	15	15
Total Revenue	\$22.50	\$45.00
Gross Profit (@ 7¢)	\$1.05	\$1.05
Cost of card acceptance (@ 2%)	\$0.45	\$0.90
Profit after Card Costs	\$0.60	\$0.15
Profit Margin after Card Costs	2.7%	0.3%

Card Issuing and Consumer Payment Behavior

This brings us to the card issuing business which influences the cards consumers have in their wallet and which card they use at the pump. As shown in Figure 3, the manner in which consumers pay for fuel has changed significantly in the past decade, including rapid growth in debit and consistent growth in fleet (Wright Express, Fleetcor, Voyager, etc.) and other third-party cards.

Figure 3: Estimated Share of Retail Fuel Payments by Payment Type



Source: The Nilson Report, U.S. Dept. of Commerce, First Annapolis Consulting estimates

Almost all of the major fuel companies now offer a full spectrum of card payment products to their customers to capture consumer loyalty and to help attract retail partners. Similarly, almost all of these programs are now outsourced to bank issuers. These issuers, like their acquiring counterparts, also profit from rising gas prices. Increases in fuel prices result in higher card spend, receivables, finance charges, and profit. For example, a 50% rise in gas prices can generate 25% or more growth in average balance over short period of time (an impressive feat in the private label business).

(Continued on Page 4)

Debit Centricity in Western European Acquiring

It is no secret that most continental European markets are highly debit oriented, with really only the U.K. and Ireland having a much stronger credit sector than debit. However, the economics of debit acquiring in Europe, as in other markets of the world, lags credit substantially. Setting aside the U.K. (which is the second largest acquiring market in the world due to its credit orientation), debit represents 62% of transaction volume in Western Europe but only 29% of acquiring earnings, according to First Annapolis estimates.

Select W. European Statistics (excluding the U.K.)	Debit	Credit
Euro Volume	62%	38%
Net Revenue	55%	45%
Pre-Tax Earnings	29%	71%

Source: First Annapolis analysis, the EC Interim Report, Visa, Lafferty, The Nilson Report

Debit economics trail credit economics primarily because of revenue dynamics. Debit net revenues per transaction are a fraction of credit revenues per transaction in Western Europe, though acquirer expenses are very similar between credit and debit, adjusting for interchange differences. (Net revenue is gross revenue less interchange and scheme fees.) The higher net revenue per transaction makes credit orders of magnitude more profitable than debit.

These net revenue dynamics are one part value proposition and one part curious historical artifact. Credit tends to have a stronger value proposition to certain merchants because the credit feature itself allows consumers to buy more than they would be able to buy otherwise. As a related matter, credit has a stronger average ticket which tends to improve the revenue dynamics, as well.

However, in most markets, the higher price point for credit (controlling for higher credit interchange) is mostly just a pricing convention with little costing, value, or competitive rationale. (Credit is also often priced ad valorem whereas debit is often priced per transaction, also simply a convention.) Historical pricing conventions in most markets evolved from early periods where banks created domestic debit schemes based largely on a retail banking rationale in which they were trying to manage branch banking merchandising strategies and cost structures and not trying to create stand alone acquiring economics, per se. Increasingly in Europe, though, acquiring is dominated by either mono-line acquirers unaffiliated with issuing or retail banking or by large net acquirers whose debit acquiring business is much larger than their debit issuing business. For these institutions, the retail banking rationale of the past is a problem.

Debit also tends to be growing at much higher rates than credit. This poses a significant portfolio mix issue for acquirers, putting

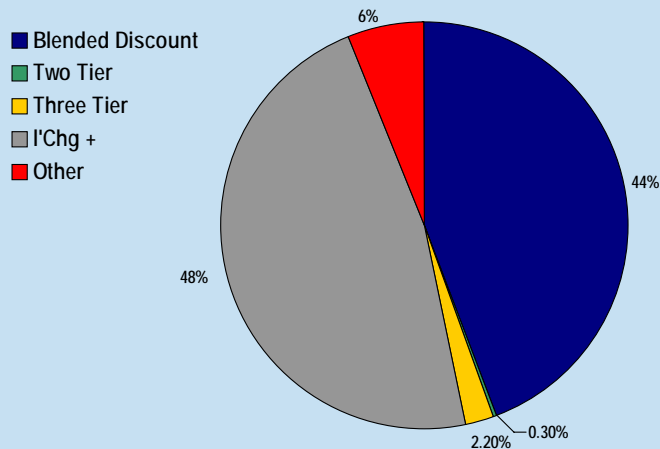
(Continued on Page 4)

## Discount Rate Structures in the Small Merchant Market

Notwithstanding years of innovation, the blended discount rate is still king as the primary pricing mechanism in the small merchant market, according to recent First Annapolis research. A blended discount rate pricing structure is a single discount rate for all card types usually accompanied by a downgrade surcharge (aka "enhanced billback"), and blended discount rates account for three quarters of merchants under \$5 million in annual Visa/MasterCard volume in the U.S. (The downgrade surcharge component of this pricing structure accounts for a whopping 20% of total industry net revenue.) So called three tier discount rate structures ("qual, mid-qual, non-qual") are the next most popular pricing mechanism for merchants of this size.

However, there is an inflection point for merchants with volume levels of \$1 million to \$5 million. Whereas below \$1 million in volume, three tier discount rate structures are 5 times more prevalent than interchange plus structures, interchange plus pricing accounts for the plurality of merchants between \$1 and \$5 million in annual volume, eclipsing even the venerable blended discount rate. That interchange plus pricing would dip so deeply in the merchant market is probably a threatening watershed for acquiring. This might mean that pricing strategies common in the mid-market have migrated to the regional and local markets. This might mean that the days of acquirers using interchange management to improve margins are numbered. These sorts of isolated observations do tend to reinforce the concept that acquirers today need to rig for the more competitively intense acquiring business of the future.

Merchants with Volume Between \$1M & \$5M



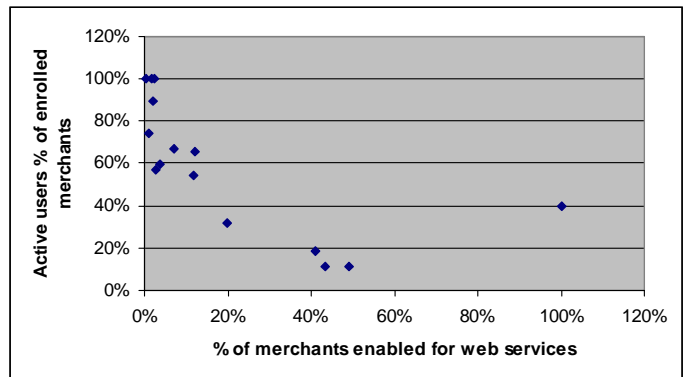
Source: First Annapolis Consulting proprietary research

For more information, contact [Marc.Abbey@firstannapolis.com](mailto:Marc.Abbey@firstannapolis.com)

## Variation in Acquirer Deployment of Web Based Services

At least on the surface, web-based services appear to have become part of the standard repertoire of U.S. acquirers, but there is a great deal of difference in the types of services acquirers deploy through the web, the tactics acquirers use to penetrate their merchant bases, and the results they see. Web based services include a wide range of offerings. On-line statements and reports distribution are a least common denominator across most offerings, but select acquirers also offer data distribution, chargeback processing, interchange benchmarking, and self-service functionality. There is a great deal of difference in the flexibility and functionality of the user interface from offering to offering as well. Acquirers also use very different tactics to deploy web services to their merchants. As a generalization, acquirers who view web services a revenue generation opportunity tend to use auto-enrollment or opt-out approaches and generate very high enrollment levels but typically low activation levels. Acquirers who view web services as part of a self-servicing strategy designed to reduce operational expenses tend to deploy web services in more of an opt-in basis, get lower penetration, but high usage among those merchants enrolled. The result is the inverse relationship between merchants enrolled in web based servicing and the percentage of users that are active users, as illustrated in the graphic below.

Web Services Statistics for Select U.S. Acquirers



Source: First Annapolis Research; U.S. Market

For more information, contact [Ramsey.Elias@firstannapolis.com](mailto:Ramsey.Elias@firstannapolis.com) and [Marc.Abbey@firstannapolis.com](mailto:Marc.Abbey@firstannapolis.com)

## Visit Our Website

Visit our website, [www.firstannapolis.com](http://www.firstannapolis.com), for access to archived versions of the Navigator and to learn more about our services. For quicker delivery and less paper, you can switch your subscription from hard copy to electronic copy. If you'd like to make the move from paper to email, contact [Kimberly.Cetrone@firstannapolis.com](mailto:Kimberly.Cetrone@firstannapolis.com).

*(Gas Price Volatility Ripples Through Continued from Page 2)*

Besides raw scale, high gas prices enhance the perceived value and therefore demand for the incentives offered on fuel cards (such as the introductory 20% off gas purchases offered recently on the Citgo co-branded credit card issued by Citigroup). According to one proprietary card issuer, response rates on direct mail exceeded historical patterns during this past spring and summer, a lift the issuer partially attributes to the national attention on gas prices. Another co-brand issuer indicated seeing a similar increase in demand for their fuel-related co-brand products during this time. Even the basic need for credit increases with rising gas prices. According to USA Today and NACS, when gas prices increased during the summer of 2005, use of credit cards increased while use of cash declined as more consumers were forced to dip into their credit to afford even routine usage of gas. Gas spending consumed 3.8% of the average American's disposable income in 2005, up from an average 2.3% during the prior ten years (according to the University of Michigan).

### Product Innovations

With so much focus on fuel cards, both by consumers and fuel retailers, product differentiation is important for the major fuel brands and there have been a number of interesting product developments in this market. Gulf Oil recently announced plans to launch a prepaid card beginning in 2007 that allows customers to pre-pay for gas at current market prices, thereby locking in the price they pay. Gulf plans to cap the price paid per gallon in exchange for a small per-gallon fee. Consumers will then have the option of paying the pump price or the price designated by his or her prepaid card.

ACH debit cards are also gaining traction in the sector. Debitman and National Payment Card have been actively signing petroleum merchants willing to take the plunge into marketing ACH cards in return for lower transaction costs. Debitman, for example, signed Wawa (a 550 c-store merchant) which will provide customers who utilize the Debitman card a \$5 gift card and ongoing cash discounts.

Meanwhile the major fuel brands are aggressively enhancing the incentives and rewards attached to more traditional co-branded and proprietary cards. For example, the aforementioned 20% off for 60 days on the Citgo MasterCard or the 15% off for 60 days on the Shell MasterCard are aggressive by historical standards. BP also recently announced a rewards program for its proprietary card, which is not a typical offering in the fuel industry.

The price of gas impacts our daily lives and the payments world is no exception. As prices rise and fall, acquirers, issuers, major oil, retailers, and consumers must all consider the implications of these movements on their respective decisions. Matters such as how an acquirer prices its discount rate and how an issuer designs a product's value proposition are influenced significantly by the price of gas. As consumers keep a close eye on gas prices posted down the street, so too then will managers in the payments business monitor the implications of gas prices. **A**

## The March of Progress for Commercial Cards in the U.K.

As with most markets in which commercial cards have been present for some period of time, the U.K. market illustrates the inroads that commercial cards can make into the B2B payment system. According to British payment association APACS, over the last ten years, commercial card transactions in the U.K. have grown 9.9% annually compared to a 1.3% growth rate in B2B payments over all. Commercial card transactions, so far, also have not been cyclical and have continued to post attractive growth rates through all of the economic downturns of the past decade. Commercial cards have increased their penetration of B2B transactions from 4.4% ten years ago to 11.0% today. Over the same time period, business checks have been the big loser having declined 3.3% annually. These sorts of results underscore the concept that, though commercial card economics for many institutions have been slow to come along, commercial cards are an increasingly important arrow in the commercial bank cash management quiver.

*For more information, contact Marc. Abbey@firstannapolis.com or Frank.Martien@firstannapolis.com.*

*(Debit Centricity in Western European Acquiring Continued from Page 2)*  
their profit margins and earnings growth under pressure. Indirectly, this issue makes it more difficult for acquirers to sustain the substantial level of low-return infrastructural investment occurring in Europe due to EMV and other factors.

Marketplace forces are having differing impacts on the credit/debit economic balance. On the one hand, regulators throughout the region tend to think of the lower debit pricing as attractive from a public policy perspective (an arguable proposition) and threaten regulatory intrusion of one form or another in credit. The SEPA initiative, however, may create a one time rationalization of debit acquiring pricing in some markets as the economic models of domestic debit schemes are forced to converge. Finally, there is some evidence of pricing innovation as acquirers themselves try to remediate the different pricing levels of credit vs. debit. In no small measure, the economic future of acquiring in Europe is dependent upon the future economics of debit, considering the relative volumes of debit and relative rates of growth.

*For more information, Yuriy.Kostenko@firstannapolis.com or Marc.Abbey@firstannapolis.com*