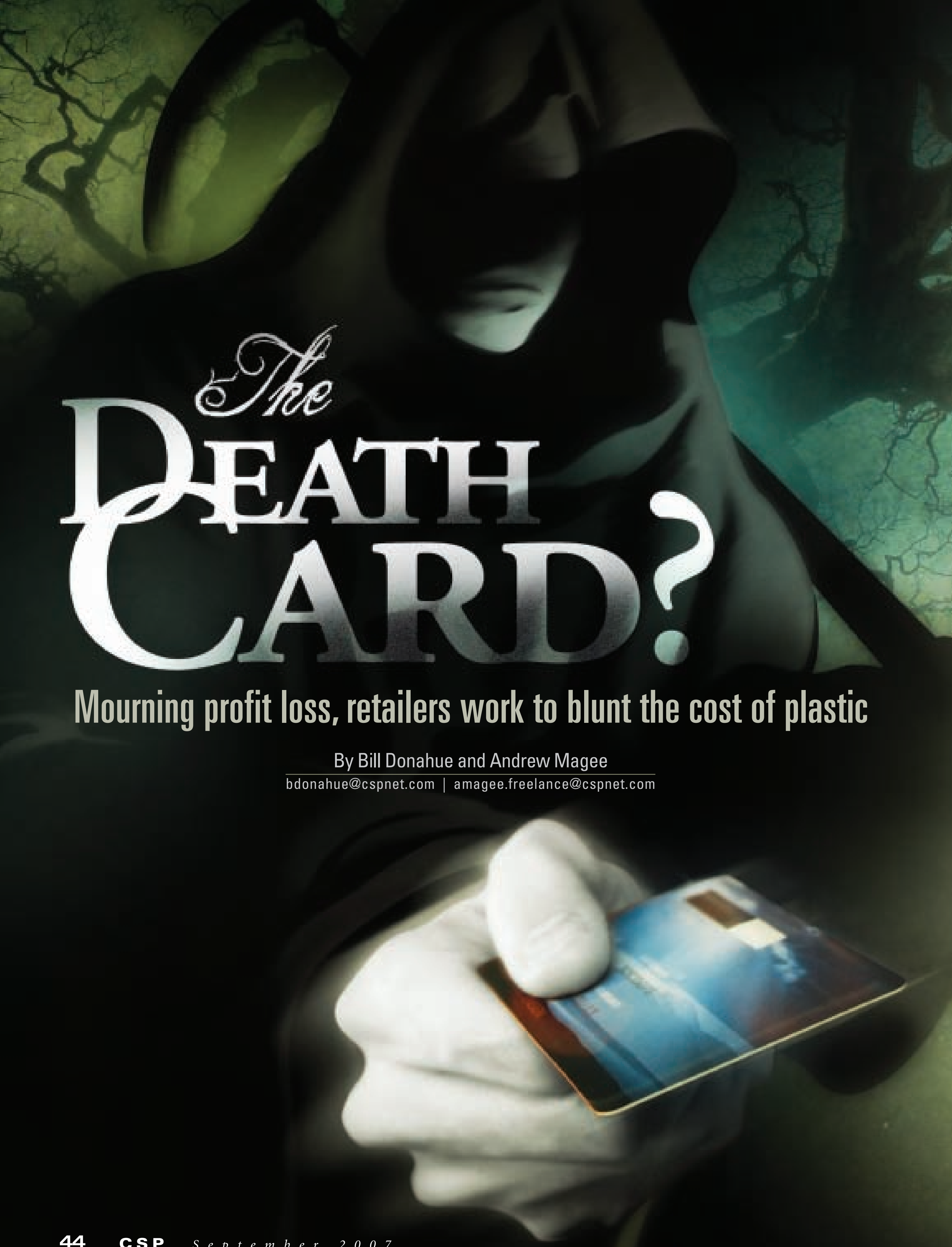

The Death Card?

Mourning profit loss, retailers work to blunt the cost of plastic

By Bill Donahue and Andrew Magee
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American consumers live in a fairy-tale world, blissfully building their dreams with the aid of someone else's money. But merchants have a much different story to tell. Theirs reads more like a Shakespearean tragedy.

The cost of accepting credit and debit cards, retailers say, has spiraled into a thorny, multibillion-dollar crisis that has forced them to miss annual profit targets, terminate expansion plans, consider digging up their fuel tanks and even shutter stores indefinitely.

Truly, no three words evoke a more visceral, vitriolic response than "credit-card fees." And rightly so, it would seem: Last year, card issuers such as Visa and MasterCard profited more from the convenience-store business than retailers themselves, to the tune of $6.6 billion vs. total industry profits of $4.8 billion, according to NACS 2007 State of the Industry data.

"It's not just about excessive fees," says Guy Oliver, president of MTG Management, an Austin, Texas-based jobbership that supplies 58 stores. "It's about being in control of your own destiny. I firmly believe that if something doesn't keep [the credit-card companies] in check, they'll keep going."

The crushing weight of credit-card fees is felt by every retailer in the business, from mom-and-pop island marketers in the Southeast to 1,000-store goliaths in the Midwest:

- A small retailer making do in the Florida Panhandle says mounting credit-card fees were the straws that broke the camel's back in his decision to cut his store count in half.
- When per-gallon retail prices climbed above the $3 mark in the Southeast, more than 90% of all transactions made at Mohammed Khan's LA Rouge Mart in a tony part of Baton Rouge, La., were made with a card.
- Many retailers have let their tanks run dry—including one New England marketer who had pumped gas at his site since the early 1970s—driven in part by mounting credit-card fees. He likens his decision to stop selling gas to "getting a divorce," based on the pain and emotional distress he endured.
- Ankeny, Iowa-based Casey's General Stores Inc., one of the industry's largest and most proficient operators, missed its 2007 profit goal of holding the percentage increase in operating expenses to less than the percentage increase in gross profit, a blow the chain attributed, at least in part, to the rising costs of accepting plastic.
- A two-tier pricing system—one for cash, one for credit—has surfaced at several retailers' stores in hopes of stopping the bleeding. One Georgia-based chain has successfully curbed credit-card fees without torpedoing inside sales or profit margins at the pump.
- A grass-roots movement to create a competitive, alternative payment system that uses the same rails associated with cashing checks, thereby limiting credit-card fees and fostering customer loyalty, has gathered steam. It's now moving past the "early adopters" stage into the phase of the "fast followers," says one industry exec.

OUT OF GAS: Dwindling fuel margins, caused in part by an increase in credit-card fees, urged Ronald Mason to shut off the gas pumps at his location in Farmingdale, Maine.

While most retailers rage over the loss of payment control and a lack of fee transparency associated with accepting plastic, some acknowledge it's not necessarily the fault of credit-card companies that merchants are so hard-pressed. If retailers didn't exist in such a margin-thin environment, they say, credit-card fees would not face such intense scrutiny.

"The cost of that credit card should be reflected in the retail of the product you're selling," says John Miller, president of 11-store Colonial Pantry Ltd., Champaign, Ill. "If you're not making enough to offset that fee, that's your fault. It's not the credit-card companies' fault."

So are credit-card companies a horde of bloodthirsty ghouls bent on draining the life force of the innocent through oligopolistic price controls? Or are they merely smart and organized juggernauts, armed with a relentless profit machine that exposes the weaknesses of an archaic industry in desperate need of repair?

"As an industry, we need to say that a credit-card fee is a cost of selling gasoline and it's a bigger percentage of that cost every day," says Miller. "The ways to offset that cost is to be more efficient, to charge more for the service or to get the person who's charging you to lower their price. Until then, I don't understand why we're eating the cost of that fee."

SWIPED!: Credit-card companies made more from the convenience-store business in 2006 than retailers themselves, according to industry estimates. As a result, many retailers have taken matters into their own hands.

The Issue of Interchange

Like retailers, credit-card companies simply want to make a profit, and they've succeeded tremendously. But the issue remains: Are they making too much at the expense of others?

Credit-card fees are split into processing fees, which are paid to middleman processors, and interchange fees, which are paid by a merchant's acquiring bank to the cardholder's issuing bank. Interchange is the most controversial aspect of fees, with many merchants, trade organizations and others suggesting the fees are tantamount to a hidden tax. It's a percentage of each transaction that credit-card firms and their member banks extract from retailers every time a customer uses a credit or signature debit card to make a purchase (see chart, p. 56).

Fees vary by card type and merchant but average 2% to 3% of each transaction. They have spurred class-action lawsuits against Visa and MasterCard that are slated to go to trial in 2008, and are the subject of hearings held by the House Judiciary Committee's Antitrust Task Force on Capitol Hill.

Opponents of interchange, who call for more transparency in such rates, suggest that credit-card companies and their banks spend only 13% of interchange on actual processing; the rest, they say, is used in marketing efforts and intricate rewards programs that do not provide a direct benefit to merchants.

The Merchants Payments Coalition (MPC), a Washington, D.C.-based organization representing close to 30 associations for the retail and restaurant industries, suggests that the collective setting of interchange fees by Visa and MasterCard is a violation of federal antitrust laws that cost merchants and their customers more than $36 billion last year, up 17% from 2005. With Visa inching up its interchange rates by 0.6% in April, consumers should expect to pay 20% more in 2007, according to MPC.

Terms such as "illegal," "price fixing" and "collusive" come up often when organizations such as MPC describe interchange. Such implications stoke the ire of weary retailers, who undoubtedly bristle at credit-card firms' recent consumer advertising campaigns, which liken the use of cash as payment to a tortoise crawl.

To be fair, credit cards provide a tremendous benefit to all retailers.

"The bottom line is that, by accepting [credit] cards, you're meeting the demands of your consumers," says T.J. Sharkey, senior vice president of MasterCard Worldwide, Purchase, N.Y. "It has a bottom-line impact. If you get more customers through your line faster, you make more money."

Peter Madigan, executive director of the Electronic Payments Coalition, Washington, D.C., agrees. While card acceptance does come at a cost to the retailer, it's a consumer convenience that has become standard procedure for most Americans—almost a competitive necessity for retailers in a hypercompetitive battlefield.

"Because of electronic payments, a countless number of retailers have been able to expand their businesses by offering their customers convenient, secure and reliable payment options," Madigan says by e-mail. "Opting for electronic payments greatly reduces the threat of theft associated with hard currency, increases protection against fraud and ensures store owners faster payment.

"From a merchant perspective," he continues, "we believe the benefits of electronic payments bring to annual sales far outweigh their business costs. The important thing to remember is, like rent, electricity or telephone bill[s], there is a cost associated with using these services and maintaining a global electronic payment system that offers

> **"Like rent, electricity or telephone bill[s], there is a cost associated with … maintaining a global electronic payment system that offers significant benefit to both the customer and the retailer."**
>
> PETER MADIGAN *Electronic Payments Coalition*

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Two-Tier Pricing and Mr. Hyde

The costs of these benefits, however, are often deemed too high. And retailers are taking matters into their own hands. Some—Michael Hyde among them—have opted for a two-tier pricing system, one for cash and another for credit.

Hyde, CEO of Pit Stop Convenience Stores, Peachtree City, Ga., implemented a two-tier pricing system at two of his five direct-operated locations more than a year ago to limit the draining effect plastic fees had on his bottom line. The move did have an almost instant effect in one regard: consumer backlash.

"We did get significant negative feedback on the front end, but over time that wanes," he says. "You do take a volume hit, and that's heresy. God forbid you should do that; let's make the oil companies and credit-card companies rich by moving more volume. 'Get your volume up and the profit will follow' is still basically true—but it's not as true as it once was."

Fuel volume dropped 40% at the two locations after the new policy went into effect, but margins changed significantly, too. Margins that had been nonexistent climbed to as much as 8 cents per gallon, according to Hyde. At the same time, thankfully, inside sales did not suffer.

"We did see [fuel] volumes fall off, but we did not see an appreciable change inside," he says. "That's a big, big highlight there. I suspected quite some time ago that we have evolved to have two sets of customers, and almost anybody would agree that 70% to 80% of customers buy gas and nothing else. Volume we had inside held steady."

Photo courtesy of National Payment Card

LICENSE TO FILL: An ACH-based payment system enables retailers to turn a magnetic-stripe-based driver's license into an alternative for credit-card use, thereby lowering fees.

Another highlight: Gallon volume that had slipped away began to creep back.

"We had seen volumes go from 95,000 to 100,000 gallons per month down to 50,000, and back up to 80,000 gallons per month," he says. "Reality out there confirmed my suspicion. I'm fully prepared to be called a heretic, but the old processes are not right."

At those two stores, the overall amount of credit-card transactions has decreased, replaced by a higher percentage of cash transactions. Despite suggestions that most consumers carry less than $20 in their wallets at any given time, the promise of lower prices has proved a tempting lure that many customers have been unable to resist.

> "Retailers will need every single tool available to them in the battle with credit-card companies for the hearts and minds of the consumers."
>
> **Peter Guidi**
> *National Payment Card LLC*

"The price we have posted is lower than the street," Hyde says. "The competition across the street is $2.96. We're at $2.92 for cash and $2.96 on credit. Everyone seems to have their hand in your pocket, but you have to try to protect yourself.

"I'm pleased with what we've done so far, but what happens next is sort of out of my hands," he continues. "I hope this [idea] expands to others than just on the interstate. On one hand I'm hopeful, but on the other I'm not too optimistic. … There'll definitely be some backlash, but like anything else in life—no pain, no gain."

Cash discounts might make a lot of sense for some retailers, but not Casey's, the majority of whose customers already pay for gas purchases with cash. Despite the fact that Casey's still transacts most of its business with good ol' dollars and cents, credit-card fees have been no less painful.

The company's annual goal for fiscal 2007, which ended April 30, was to hold the percentage increase in operating expenses to less than the percentage increase in gross profit. Credit-card fees and other expenses prohibited Casey's from meeting that goal. Total gross profit for the year increased 10.9%, while expenses rose 13.4%, primarily due to a 31% increase in total

Reversal of Fortunes

Credit-card fees surpassed industry profits in 2006—an industry first. The cost of accepting plastic climbed 22% for the year, while retailer profits dipped 24% on combined motor-fuel and in-store sales of nearly $570 billion.

Year	Industry sales ($ billions)	Industry profits ($ billions)	Credit-card costs ($ billions)
2003	$337.0	$4.0	$3.2
2004	$394.7	$5.0	$3.8
2005	$474.3	$5.9	$5.4
2006	$569.4	$4.8	$6.6

Source: NACS 2007 State of the Industry survey

credit-card fees. Such ballooning costs spurred Casey's to take its card-processing in-house, a move the company completed May 1, according to Bill Walljasper, CFO of Casey's.

"That should mean for us roughly $1 million to $1.2 million in savings to mitigate that flat fee," says Walljasper, whose company has 1,463 corporate and franchised stores in the Midwest. "Already 55% to 65% of our customers pay with cash, so offering a cash discount would be counterintuitive. But this [change] will certainly help alleviate some of the operating costs."

State of Transition

In June, Claude Duvall paid more than $10,000 in credit-card fees at his two stores. He took a much different approach to dulling the effects of such "outrageous" costs, as he calls them.

The sky-high costs of accepting plastic forced his fuel supplier, which had been absorbing the fees, to change its policy. As a result, he then had to take the brunt of the charges. That significant change in monthly expenses contributed to his decision to sell one of his Local Yokel stores, leaving him with just one in Milton, Fla.

While credit-card fees definitely factored into his decision to pare his store count, insurance costs, utilities expenses and more stringent underground-storage-tank regulations also forced his hand.

"Three years ago, I was paying a little over $15,000 [in insurance]," he says. "This year, I'm paying a little over $38,000 for less coverage because of all the hurricanes. Our electric bill went up 10% the first of the year. It doesn't sound like a lot, but if you're paying $7,000 per month in electric, it's a lot."

Market forces beyond his control, he believes, are making it very difficult for small businesses such as his to survive. He'd like to see credit-card companies lower their rates to make the costs of accepting plastic more "fair."

"When you make a percentage of the sale, it's not fair when my retail doubles or triples and they continue to take more money because of that," he says. "It should be a flat number, plus a fee for the processor, but 14 to 15 cents for the processor per transaction isn't fair either."

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>
> John Miller *Colonial Pantry Ltd.*

Other business owners, meanwhile, say the cost has forced them to change the entire makeup of their business. In Farmingdale, Maine, the small, two-pump fuel island at the Airport Automotive station no longer sells gas. Owner Ronald Mason let his full-serve station run dry in May, a decision he'd been mulling for more than a year.

"It wasn't just credit-card fees, but it was a kicker," says Mason, who began working at the station in 1973, and purchased it in 1995. "When you're only making 6 or 7 cents a gallon in profit margin, and people are using debit cards the same as credit cards, it eats up your profit, especially when the price is up to $3 a gallon.

"You're paying a 2% to 3% processing fee," he continues, "and that's 2 cents out of your own pocket—not including [the costs of paying] the man pumping the gasoline."

Last year, Mason lost 8.03 cents per gallon selling gasoline, a figure he calls "conservative." To limit his losses, he reduced staff to one full-time person, while he covered nights and weekends. While that slowed the bleeding, it wasn't enough.

"We're doing a lot of repairs, but when you're selling gas for that long and then you're not, it's like getting a divorce," he says. "But you gotta bite the bullet and break out of that box."

When he was pumping gas, as much as 70% of transactions were made with a credit or debit card. He still accepts

A Wider Problem

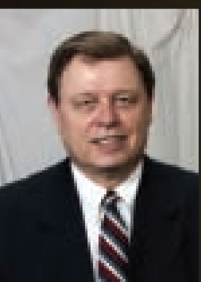
"I just want to say one word to you. Just one word: plastics."

These words from Mr. McGuire to Benjamin Braddock, played by a young Dustin Hoffman in the film classic "The Graduate," could have easily been referring to America's insatiable appetite for credit cards.

America is a credit-card culture. While that's now a fact of life, the marketplace as it's currently structured isn't set up to allow for the fees merchants pay as a result—assuming marketers actually want to make some money, according to George Minkevich, chairman of two-store G.N.W. Enterprises, St. Louis.

"We don't have the margin to absorb 7 cents to 9 cents per gallon on a credit card," he says. "We have to hope that we get them in the stores or go out of business. Our distributors have told us the same thing. They tell us to add a profit center or increase the store size and profit mix. Some of us are saying that's a bunch of baloney."

Minkevich remembers fees being little more than a "pittance," back in the days when oil companies offered cash/credit choices at the pump, a practice long since renounced.



"The only solution," he says, "is for Big Oil to revert back to what they had in the '80s and '90s and that it acknowledge the profit a retailer will make on a gallon of gas is not going to be great enough to cover credit-card costs … and, at the same time, keep enough gross profit to run a viable business in the future."

He'd like to see Big Oil provide retailers with the option of allowing retailers to negotiate for themselves with processor companies. NACS, for example, offers a card-processing program to retailers for a flat rate of 6.15 cents per transaction, not including interchange. (Nonmembers pay 7.15 cents per transaction.) Average per-store savings to the retailer should be an estimated $4,257 per year, according Doug Spencer, NACS' manager of products and services.

But Minkevich has another idea: Why doesn't Big Oil take one for the team and just soak up the fees for its marketers and "instead of making $13 billion per quarter, they could make $11 billion per quarter"?

"In our stores," says Minkevich, "we're spending an average of $5,000 to $7,000 per month per store on credit-card fees and we wonder why we're not keeping any money. … Yes, credit cards build volume. However, when you're losing money on every gallon, more volume means more losses."

plastic for auto-repair services, but he says it's not as dramatic an expense because he has more control over pricing—and, therefore, margins. Plus, he says the site now brings in more money because he and his crew have more time to concentrate on repairs because they're not constantly leaving the bay to play the role of pump jockey.

Mason now faces a tough decision.

"Do I continue to keep the pumps closed?" he says. "I'm waiting it out, to see if it affects the bays. At this point, it's a little premature to make the decision. I can put them back in service. I have one year from the time I took them out of service."

Otherwise, he has to pay to have the tanks and pumps removed. That, too, will come at a substantial cost, but the case for not selling gas seems pretty strong.

"I've had quite a few different savings, in addition to the fees, including a few I didn't even expect to gain," he says. "The electricity bill, for one, and uniforms were another. And when you're flying a major brand, you pay monthly to put that sign out there. We paid $105 per month just to put a sign out on the street.

"I was very stubborn, and nobody could convince me," he continues. "I had to convince myself. My accountant was telling me for three years, 'How long are you gonna let this black hole suck you down?'

"I hung in there as long as I could, but I've seen a big difference in my checking account."

Alternative Lifestyles

For some retailers, the road to lower credit-card fees was paved in the wake of the terrorist attacks of Sept. 11, 2001. With transportation systems stalled in the aftermath of the attacks, banks were unable to transport and clear checks, which led to a bloated increase in their daily float and underscored the need to overhaul the nation's outmoded payment system.

This inadvertently provided a gateway for alternative payment systems that ride on the rails of the Automated Clearing House (ACH) network for processing checks electronically.

"Many of the top oil companies are evaluating how to utilize ACH today," says Peter Guidi, vice president of sales for National Payment Card LLC, Boca Raton, Fla. "There is a revolution coming in the payment marketplace, and retailers will need every single tool available to them in the battle with credit-card companies for the hearts and minds of the consumers. [Credit-card

'On the Verge'

Flash Foods Inc., Waycross, Ga., believes it holds the key to lower card costs, and its name is "Rewards in a Flash." The chain has had this proprietary electronic loyalty program, which has helped boost the average ring, in place for two and a half years.

With 550,000 loyalty-card holders shopping its 178 stores in Georgia and Florida, the chain hopes to harness the power of the Automated Clearing House (ACH) network to turn loyal customers into savings on credit-card transactions.

"We are on the verge," says Jenny Bullard, chief information officer for Flash Foods. "Because of the cost of processing credit, we've been looking at taking our loyalty and making it an ACH for our customers. You pay a much lower fee for ACH than we pay for the average credit-card transaction.

"Part of that savings," she continues, "goes to the bottom line, and the other part will be extended to our customers by giving them more cents off per gallon if they pay with the loyalty card. We're going to be introducing it this fall."

The program ties the existing loyalty program, crafted with software supplier The Pinnacle Corp., Arlington, Texas, to the ACH-based program from National Payment Card LLC, Boca Raton, Fla.

Approximately 52% of Flash Foods' sales are made with a credit card, and Bullard estimates that the average plastic transaction costs Flash Foods 57 cents to process. The ACH transaction will cost 15 cents.

"If we convert 5% of our loyalty cards into ACH cards," she says, "we'll save over $200,000 in the first year alone."

companies] have stolen the consumer, and they've confiscated the profits."

National Payment Card has developed a system designed to "extend the retailer's customer relationship into payment," says Guidi. "Retailers have a huge opportunity to create this new relationship. Extending the brand … will require more than a sticker on the door that says, 'MasterCard and Visa accepted here.' "

> "There'll definitely be some backlash, but like anything else in life—no pain, no gain."
>
> **Michael Hyde**
> *Pit Stop Convenience Stores*

The program, which works with VeriFone, Gilbarco and Pinnacle point-of-sale solutions, uses magnetic-stripe-based driver's licenses, loyalty cards and "third-party card decks with significant distribution," says Guidi. The system essentially turns existing cards into private-label debit cards and charges retailers a fixed fee of 15 cents to 17 cents per transaction. That could be a savings of 80% or more compared to fees imposed by credit-card issuers, depending on the size of the transaction.

Oliver of MTG Management implemented the National Payment Card system in one store starting Jan. 5, 2007, using Texas' magnetic-stripe-based driver's licenses as the payment method. He characterizes the startup costs as "fairly minimal," mainly because the store already had a VeriFone Ruby system in place. He's been so happy with the system that he invested a small amount of money in the company.

"As I've told anyone who will listen, we're working on legislative fixes, but I don't think they'll do anything until competitive pressure comes to bear," Oliver says. "Anyone who knows me knows I have two passions: health-care costs and credit-card fees. It's not just the fee; it's the infrastructure to support the fee."

The National Payment Card system doubles as a loyalty program; fees that would have been paid to credit-card companies are fed back to the consumer in the form of cents off per gallon (see sidebar, left). Even with the cost of the price rollback, retailers should experience a quick return, according to Guidi: Given a minimum of 14 transactions per day, retailers should realize a return on their investment within a year.

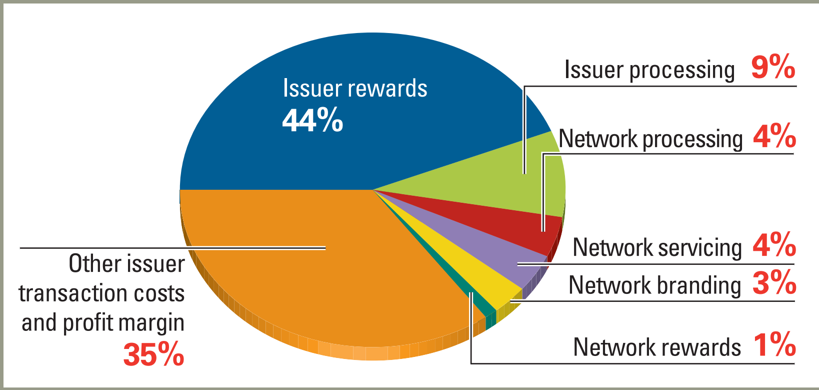
"If I'm going to give someone money, I'd rather give it to the consumer," he says. "We offer a 10-cent-a-gallon discount to the consumer, and that encourages them to sign up. When you see a 10-cent-a-gallon difference, it's going to resonate. They might not sign up the first time they see it, but by the third, maybe fourth time, they're going to be wondering, 'How can I get this 10-cent-per-gallon discount?' "

Tempo Payments Inc., San Mateo, Calif., has built another program on the back of ACH. Prominent users include QuikTrip Corp., Wawa Inc. and WESCO Inc. The investment to the merchant from an acceptance perspective is next to nothing, according to Anthony Ruebner, vice president of business development and relationship management for Tempo. It's simply a matter of contacting a processor, he says.

"If a customer is filling the tank for $50, and you're using a bank-issued credit card or signature-debit card with

Pieces of Interchange

Rewards programs and advertising/marketing costs account for a combined 47% of the total interchange cost, according to a report from Diamond Management & Technology Consultants, Chicago, called, "A New Business Model for Card Payments."



Source: Diamond Management & Technology Consultants Inc.

an interchange rate of 2%, then 2% of $50 is $1," he says. "The merchant has to carve out $1 just to have accepted that tender type. If they migrate to Tempo, the cost is 14 cents. Going from 14 cents to $1—that's an 86-cent impact to profit."

Muskegon, Mich.-based WESCO talked to Tempo Payments, then known as Debitman, for more than a year in considering implementing the system, according to Bryan Link, director of marketing for the 51-store company. The process did take some education of consumers because it's essentially introducing consumers to a new type of payment.

"On the plus side," he says, "once everybody is educated, there are savings to the company as well as savings to the consumer—it's a pretty easy thing to comprehend. I don't have a figure to say we save 'X' amount, but it's enough to warrant the continuation of the system and the investment we make in marketing it."

WESCO began testing the Tempo system in May at two stores Link refers to as "more geographically remote from our other locations." The system, which uses a WESCO-specific card created by Tempo, incents the customer with 2 cents off per gallon. The company teased the system to customers through applications at the pumps, at an in-store table, stuffed in bags, through direct mail and offered by associates. So far, WESCO has created a base of more than 4,000 customers toting Tempo cards.

A recent survey showed that, of WESCO's Tempo users, 69% of them converted from higher-paying cards, namely credit and signature debit, while 27% came from users of cash and checks.

Not everyone is sold on ACH payment as an alternative.

"The challenge to ACH payment methods is incenting customers to a new way of doing business," says Rich Steckroth, director of business development for Sheetz Inc., Altoona, Pa. "By the time you incent the customer to change something, the cost of that incentive usually takes you back to the same challenge, and now you're trying to change consumer behavior while paying the same amount."

'Very Appealing'

In an ACH scenario, the consumer essentially gives the retailer access to his or her bank account. And for that to happen, the consumer needs a significant incentive, such as the gas discount. Even so, it's not proven that current incentives are enough to make customers want to "convert," according to Anton Bakker, president and CEO of electronic-loyalty provider Outsite Networks, Norfolk, Va., whose firm supports ACH payment methods for retailers using ACH-enabled POS platforms.

"From a technology point of view, it's very appealing to come up with a system to lower these costs, but what has not been proven to me is how many consumers will actually do that," he says. "What we encourage people to do is use [our] loyalty system to incent customers to use a particular method of payment that has a lower transaction cost rather than creating a whole new payment mechanism in parallel to the one that already exists."

Guidi, Ruebner and Oliver, however, all suggest that ACH-based systems are maturing quickly. They may be onto something. Nearly 16 billion ACH payments were made in 2006, a 14.5% increase over 2005, according to statistics compiled by NACHA, the Chicago-based Electronic Payments Association. But it's going to need some help to get to the next phase.

"It's got to get some traction," Oliver says. "When they say they've signed up a 300-store chain or a 500-store chain, the industry will go out and take notice. … I don't like talking to the press, but I am because I feel so strongly about it. When 10%, 20% or 40% of the industry does something like this, the credit-card companies will be forced to react."

There's no silver bullet to solving the issue of rising credit-card fees—no perfect payment system, no magic spell able to be cast that would fix the issue and make the problem neatly disappear. What is clear? Convenience bears a heavy price.

"I think the credit-card companies are wrong," says Miller of Colonial Pantry, "but I think we [the retailers] are wrong for not compensating by charging more to cover that fee. The industry will have to wake up. … Over time, hopefully we will realize that it's not a crime to raise the price on a gallon of gas." ■