



TESTIMONY OF STEVEN C. SMITH

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K-VA-T FOOD STORES, INC.**

AND

**CHAIRMAN OF THE BOARD
FOOD MARKETING INSTITUTE**

CREDIT CARD INTERCHANGE FEES

**THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON THE JUDICIARY
ANTITRUST TASK FORCE
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Chairman Conyers and Members of the Committee, I am honored to appear before you today and present information of great concern to my company, K-VA-T Food Stores, Inc., the members of the Food Marketing Institute and American consumers.

I serve as President and CEO for K-VA-T Food Stores, Inc., a retail supermarket chain operating 95 stores under the Food City banner in Kentucky, Virginia and Tennessee. We are a family owned business, dating back to 1955. 16% of our company is owned by our associates through our Employee Stock Ownership Plan and we currently employ over 11,000 associates.

Also, I serve as Chairman of the Food Marketing Institute, commonly referred to as "FMI". FMI is a national trade association that has 1,500 member companies made up of food retailers and wholesalers in the United States and around the world. FMI's members operate approximately 26,000 retail food stores with combined annual sales of \$340 billion, representing three quarters of all retail food store sales in the United States. FMI's retail membership is composed of national and regional chains as well as independent grocery stores. Our international membership includes some 200 companies from 50 countries.

I am here today to shed light on the best kept secret of the credit card industry; that is, the great hidden tax that has been thrust upon consumers due to ever increasing interchange fees that credit card companies charge retailers as a result of collective price setting by Visa and by MasterCard and their respective card-issuing banks.

This collective price setting—which looks to me like price fixing under the antitrust laws—does not occur in isolation. Rather, it is part and parcel of a system that imposes collectively-set rules that effectively require merchants to keep the cost of accepting cards secret from their customers. The rules also prevent merchants from refusing to accept particular types of credit or debit cards that impose higher fees. Thus, the card systems can, and do, increase their collectively-set interchange fees without any fear of resistance by their card holders who remain unaware of the increased costs they are imposing and incurring.

My testimony today will focus on three topics: First, I would like to give you some understanding of the supermarket industry in today's marketplace; Second, the history of electronic payment transactions in our industry; and last, the effect of interchange fees on the retail industry today and the hidden "tax" burden it has laid upon the consumers.

The grocery industry is comprised of all types of businesses – from national "big box" chain stores to the traditional "mom & pop" store on the corner. It is my opinion that this industry serves a broader cross-section of the American public than any other retail industry. Each of those consumers enjoys a very competitive marketplace that exemplifies what most Americans believe their free enterprise system to be – specifically, each member of our industry has to fight, each and every day, to offer the consumer the best product at the fairest price in order to win them as a customer.

Because of this healthy competition, the profit margin in the grocery industry is generally in the 1% range; that is, our operators generally only make \$1 of profit for \$100 of sales. I like to say that we are a "penny" business – I know of no other industry that operates in such a competitive, low-margin environment.

Back in the early 1990's, supermarkets first began experimenting with credit and debit card acceptance. When we signed on to accept credit/debit cards, the issuing banks actually paid retailers to accept their cards and offered a variety of incentives to entice retailers to "sign up" and join the system.

Over time, our interchange fees were increased. And even though our profit margin was right around 1%, the same amount as our 1% introductory interchange fees, the initial volume of credit card payments was low. The industry fully expected that the rate charges would fall as transaction volume increased – this would be consistent with basic economic theory and our experience with various other aspects of our business. However, the exact opposite proved true.

Today consumer use of credit and debit cards is at an all time high, with 60-65% of all payments in our industry made with plastic. As the credit card payment method has

become more and more prevalent, and interchange fee rates have increased, our interchange fee volume began to increase exponentially -- resulting in a 700% increase in total interchange fees over the past 10 years. Today's high rate of credit card usage combined with the fact that credit card companies are allowed to collectively set interchange rates leaves retailers faced with a take it or leave it system – basically it comes down to a decision to either swallow hard and pay high fees that are set with no competitive influences or turn your back on the 65% of your revenue from customers who have been influenced by the card industry's advertising to believe they are social outcasts if they pay with actual cash. The retailer's only practical option is to "pay up" and be forced to pass this uncontrollable expense on to consumers.

Because of these factors, the grocery industry now faces credit card interchange fees that can be up to 2% or more of a sale. Please recall my earlier statement that our industry is a "penny business" or 1% of sales. Therefore, the effect is that fees set collectively by the credit card companies are now double the industry's profit margins.

As FMI Chairman, I represent 26,000 retail food stores with combined annual sales of \$340 billion, or three quarters of all retail food store sales in the United States. These retailers have all been put in the position of having to pass-along the costs of these credit card interchange fees. As a result, consumers pay over \$4 billion annually in FMI member stores and because the fees remain hidden, they don't even realize it!

To the "injury" of higher interchange fees, our members must add the "insult" of the anticompetitive, Visa and MasterCard Operating Rules. These rules prevent stores from setting minimum charges; require retailers to accept all cards, even premium rewards or corporate cards which carry a higher interchange fee and are not available to the majority of consumers; don't permit retailers to make preferences based on card type or even payment type; and prevent retailers from reviewing the rules of practice without obtaining a signed nondisclosure agreement.

In the grocery industry, our very survival depends upon customer attraction and retention amidst an intensely competitive marketplace. Every entity of the retail world is faced with some form of competition - from the contractors that build our stores and

suppliers that provide our products to our utility companies. This competition serves as a safeguard to ensure that our practices and prices remain in check.

Yet the reverse is true of credit card companies. Visa and MasterCard, accounting for 80% of industry transaction volume, each work collectively with their members to drive rates upward rather than maintaining a healthy balance. In their non-competitive market, normal pressures do not apply. Visa regularly increases its collectively-set interchange fees to encourage the issuance of its cards and MasterCard does the same. Meanwhile, the unsuspecting consumer is the conduit for this rise in fees—thanks in part to those collectively-set rules that prevent merchants from responding competitively to the increased cost of particular types of cards. The only beneficiaries are those lucky few who qualify for the premium cards packed with rewards on airline miles, cash back, hotel rooms, etc. But even they often find that the greatly touted rewards programs lack the promised substance.

My company operates 95 stores in 3 states. We see credit cards from every state in the country and I have yet to find even one bank that chose to offer an interchange rate lower than those collectively set and agreed upon by Visa or MasterCard. Fair and rigorous competition is the foundation of our industry. We are not lobbying to deny credit card companies their reasonable profit. We only ask that we not be faced with costs imposed on us that have been set collectively by card systems and their member banks, in an environment that is deliberately and collectively designed to deprive America's merchants of any freedom of competitive action: given Visa and MasterCard's market share we simply don't have the ability to say "no" to the card systems' all-or-nothing proposition.

The conventional wisdom tells us that as volume grows prices should fall, but instead credit card companies have created much greater volume AND raised fees and costs substantially. This is contrary to the basic concepts of the American free enterprise system. This situation is the result of card systems controlling 80% of industry volume collectively setting prices in violation of the antitrust laws. And the great shame of it all is that the consumer bears the costs and this fact has been effectively hidden from them. I hope that you can work with representatives of FMI and other merchant groups

to develop solutions to end the anticompetitive conduct of the major card systems. I know of no other industry which is allowed to blatantly abuse both the consumer and the retailer. Credit card companies should be required to operate in the same competitive environment as every other facet of business throughout our nation.

Thank you for the opportunity to testify.