

Ms. Louise Roseman  
Director  
Division of Reserve Bank Operations and Payment Systems  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551

November 17, 2010

Dear Ms. Roseman,

Re: Section 1075 of the Dodd Frank Act related to debit card interchange fees.

The American Bankers Association (“ABA”) appreciates the challenge to the Federal Reserve Board (“Board”) in implementing Section 1075 of the Dodd Frank Act related to debit card interchange fees. Although the banking industry is a diverse and competitive market unlike power companies, the experience and precedent of utility rate making might offer the Board useful guidance in determining interchange transaction fees that are “reasonable and proportional” to the issuers’ cost, pursuant to Section 1075. Accordingly, we submit the attached document, “Setting Reasonable and Proportional Interchange Transaction Fees and the Utility Rate Making Experience,” prepared for the ABA by Robert Loeffler and Bruce Barnard from Morrison & Foerster LLP.

Regards,

Nessa Eileen Feddis

**SETTING REASONABLE AND PROPORTIONAL  
INTERCHANGE TRANSACTION FEES  
AND  
THE UTILITY RATE MAKING EXPERIENCE**

**Prepared for the  
American Bankers Association**

**By**

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**November 2010**

Section 1075 of the recent Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”)<sup>1</sup> amends the Electronic Fund Transfer Act (“EFTA”) to require the Board of Governors of the Federal Reserve System (“Board”) to regulate interchange transaction fees. While the Act raises challenging issues that may be new to the Board relating to regulatory rate-making, the experience of other federal agencies and related judicial precedents offer a useful resource and practical solutions to the rate-making issues facing the Board

The Act provides that: “The amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transactions shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”<sup>2</sup> The Act also directs the Board to issue regulations that will “establish standards for assessing whether the amount of any interchange transaction fee [described in paragraph (2)] is reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”<sup>3</sup> The Act further provides that, in prescribing regulations to establish standards for assessing whether the amount of any interchange transaction fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction, the Board shall distinguish between “the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction” and “other costs incurred by an issuer which are not specific to a particular electronic debit transaction.”<sup>4</sup>

The Act raises a number of key issues, including:

1. Must rates be based on individual issuer costs or can rates be established that are based on groups of issuers?
2. What costs should be considered as a basis for determining whether rates are reasonable and proportional?
3. Should the costs and revenues of debit card transactions be viewed separate from the costs and revenues of other aspects of deposit accounts?

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<sup>1</sup> Pub. L. No. 111-203, § 1075, 124 Stat. 1376, 2068 (2010) (adding 15 U.S.C. § 1693o-2).

<sup>2</sup> 15 U.S.C. § 1693o-2(a)(2).

<sup>3</sup> 15 U.S.C. § 1693o-2(a)(3)(A).

<sup>4</sup> 15 U.S.C. §§ 1693o-2(a)(4)(B)(i), (ii).

4. Does reasonable and proportional include a return on investment or profit?

The Federal Energy Regulatory Commission (“FERC”) and its predecessor the Federal Power Commission (“FPC”) have three quarters of a century of experience and precedent in establishing and applying regulations to determine the “just and reasonable” regulated rates for public utilities providing wholesale electricity and transmission of electric power in interstate commerce, wholesale natural gas sales (now deregulated) and interstate natural gas pipeline transportation, and interstate oil pipeline transportation. The Board can look to this experience to help it form an efficient and practical framework for determining allowable interchange transaction fees that are reasonable and proportional to the costs incurred by the issuer with respect to the transaction.

### **The Rate-Making Process**

Before turning to the key issues raised by the Act, a brief background on utility rate making may be helpful. The fundamental concepts of utility rate making are well understood and widely applied at both the federal and state levels. The electric power industry in the United States is a complex and diverse combination of business sectors subject to local, state, and federal regulation or in some cases no regulation at all.<sup>5</sup> Regulation of the industry has traditionally been imposed through cost-of-service ratemaking with extensive adversary hearings before the regulatory body on all costs, during which the utility is charged with proving, by a preponderance of the evidence, that its proposed rates, and all the costs that make up those rates, including the utility’s proposed return on invested capital (its profit), are “just and reasonable” according to the rules and precedents of the regulatory body.

At the other end of the regulatory spectrum, at the Federal level, some utilities are authorized to sell some regulated commodities or services at “market-based rates” – at whatever price the applicable market sets for the commodity or service. The FERC authorizes a seller to market its commodities or services at market-based rates only after the seller demonstrates that it

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<sup>5</sup> There are numerous utilities that exist outside the purview of either State or Federal regulatory bodies. Neither the historical development of this sector nor its rate-making practices are pertinent to the subject of this paper.

does not, either alone or in combination with its affiliates, possess market power in the market in which it will sell the commodity or service in question.

Between these extremes, there are myriad variations that have arisen over the last century to address perceived shortcomings of the traditional rate-making process and to address other social, political and economic issues. One of the more significant perceived shortcomings of the traditional ratemaking process that has been addressed over the last 40 years has been that the process is overly cumbersome, slow and expensive, and unable to accommodate fluctuating costs. For example, rapid changes in energy prices led to the pendency of overlapping, or “pancaked” rate cases.

In contrast to past rate-making proceedings, the Act presents the Board with a relatively flexible, regulatory approach that requires the Board only to set standards for rates that are reasonable and proportional to costs. As discussed in greater detail below, this flexibility should allow the Board to establish standards that are both administrable and that allow for interchange transaction fees that permit debit card transactions to stand on their own two feet without cross subsidization of, or from, other deposit account services. Nevertheless, in arriving at these standards, the learning derived from the historical rate-making process can help the Board resolve key issues raised by the Act.

### **Rate-Making Framework**

An initial issue that the Board must resolve is the framework and procedure it will use to determine rates. Stated differently, the Act raises the question of whether the Board could establish a rate framework and methodology that ensures that allowable interchange transaction fees are reasonable and proportional and include only allowable costs while avoiding unnecessarily burdening the Board, its staff, and the industry with a cumbersome review process for individual rates on an issuer-by-issuer basis. We believe that the Board is not bound to establish rates on an issuer-by-issuer basis. For example, we believe that, consistent with the FERC experience and applicable Supreme Court precedent, the Board could establish an average effective interchange rate that any issuer may receive or charge for all debit transactions and then allow payment card networks to establish individual interchange rates so long as the effective

average of the rates ultimately charged through the network is consistent with the Board-established rate. Such a framework would create rates that are relatively easy to monitor, enforce, and periodically update as necessary. The alternative of establishment of an individual interchange rate or group of rates for each issuer would require the Board to dedicate a significant portion of its time and its staff to this activity. An examination of the FERC experience supports the establishment of a rate of general application, such as an effective average interchange rate.

FERC's predecessor, the FPC, was faced in the late 1950s and early 1960s with establishing rates for producers of wellhead gas in the Permian Basin of Texas and New Mexico. After years of litigation, the FPC established three regions for the Basin and established area-wide prices for each region. In its order approving the FPC's action, the Supreme Court first described the FPC's efforts and frustrations in attempting to determine just and reasonable rates for individual producers and then described the FPC's ultimate action as:

The Commission declined to calculate area rates from prevailing field prices. Instead, it derived the maximum just and reasonable rate for new gas well gas from composite cost data, obtained from published sources and from producers through a series of cost questionnaires. This information was intended in combination to establish the national costs in 1960 of finding and producing gas well gas; it was understood not to reflect any variations in cost peculiar either to the Permian Basin or to periods prior to 1960. The maximum just and reasonable rate for all other gas was derived chiefly from the historical costs of gas well gas produced in the Permian Basin in 1960; the emphasis was here entirely local and historical.<sup>6</sup>

Upholding the action of the FPC, the Supreme Court determined that area maximum rates, determined in conformity with the Natural Gas Act ("NGA"), and intended to balance investor and consumer interests, are constitutionally permissible:

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<sup>6</sup> *Permian Basin Area Rate Cases*, 390 U.S. 747, 761 (1968) ("*Permian Basin*").

Accordingly, there can be no constitutional objection if the Commission, in its calculation of rates, takes fully into account the various interests which Congress has required it to reconcile. We do not suggest that maximum rates computed for a group or geographical area can never be confiscatory; we hold only that any such rates, determined in conformity with the Natural Gas Act, and intended to “balanc[e] . . . the investor and the consumer interests,” are constitutionally permissible. *FPC v. Hope Natural Gas Co.*, *supra*, at 320 U. S. 603.<sup>7</sup>

It should be noted that, similar to the language of Section 920 of the EFTA, as amended by the Act, the NGA at that time required that rates received by “any natural gas company” must be just and reasonable. The Supreme Court addressed whether the FPC exceeded its mandate under the NGA:

There are, moreover, other factors that indicate persuasively that the Natural Gas Act should be understood to permit area regulation. The Act was intended to create, through the exercise of the national power over interstate commerce, “an agency for regulating the wholesale distribution to public service companies of natural gas moving interstate”; it was for this purpose expected to “balanc[e] . . . the investor and the consumer interests.” This Court has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred. Surely the Commission’s broad responsibilities therefore demand a generous construction of its statutory authority.

Such a construction is consistent with the view of administrative ratemaking uniformly taken by this Court. The Court has said that the “legislative discretion implied in the ratemaking power necessarily extends to the entire legislative process, embracing the method used in reaching the legislative determination, as well as that determination itself.” (Cites and footnote omitted.)<sup>8</sup>

The language of *Permian Basin* and the wording of the NGA support the view that it is within the Board’s discretion, for example, to adopt a framework and methodology that would establish

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<sup>7</sup> *Permian Basin* at 390 U. S. 770.

<sup>8</sup> *Permian Basin* at 390 U. S. 776.

a standard for interchange transaction fees that applies to issuers generally, and these allow for the establishment of rates for those transactions rather than establishing rates on an issuer-by-issuer basis.<sup>9</sup>

### **Cost Considerations**

A second issue that the Board must resolve is a determination of which costs will be recoverable as a part of the interchange transaction fees to be established. Under the Act, the Board has discretion to consider issuer costs other than incremental costs for authorization, clearance and settlement, narrowly defined, so long as those costs are specific to debit card transactions. Supreme Court precedent supports this interpretation of the statute as well as FERC practice and policy. The Board can consider, in the context of its rule making, which costs will be deemed to be incurred in connection with an issuer's debit card operations and, therefore, recoverable through its interchange transaction fees.

The FERC has a wealth of experience and precedent to which the Board can look for guidance. In looking at that precedent, it is helpful to understand the historical development of the regulatory structure within which the rates are determined. Determining, on a case-by-case basis, which costs are allowable costs to be included in a regulated rate has long been a focus of rate making at the FERC. This determination has traditionally been made through a formal, cumbersome adversary regulatory review process. Such a process imposes significant requirements on both the regulated and the regulator. For example, the FERC requires that all regulated utilities use a uniform system of accounts to track all allowable costs.<sup>10</sup> When the utility wants to establish or change a rate, it has been required traditionally to file an application to establish a new rate, which triggers a formal trial procedure regarding the proposed rate. This process can routinely take 18-24 months for a single, major rate case. While this was manageable when costs were relatively stable and rate changes were required only infrequently to keep up with changes in costs, as markets for fuels and other costs became more dynamic and costs for capital less stable, utilities found it necessary to apply for changes much more

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<sup>9</sup> The Board may also have the authority to provide special relief for exceptional circumstances; however, if the Board adopts a rate structure that is sufficiently flexible, such relief may not be necessary.

<sup>10</sup> See e.g., 18 C.F.R. Part 101 for the FERC Uniform System of Accounts used for electric utilities. The listing and description of accounts alone takes 129 pages in the latest publication of the regulations.

frequently. As this led to problems such as “pancaked” rates,<sup>11</sup> the FERC sought more “light-handed” methods of rate making that could more rapidly and efficiently respond to market changes. Fortunately, the Act does not burden the Board with an adversarial process. Instead, the Board can establish standards for rates through a regulatory process. Moreover, such standards can include one or more safe harbors to facilitate compliance with the standards.

For example, the Board’s regulations could provide guidance as to which costs will be allowable for inclusion in the interchange transaction fee. As noted above, the Act limits allowable costs to those that are related to debit card transactions. The Act also establishes the standard that any interchange fee that an issuer may charge must “be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” Further, the Act requires the Board to distinguish between the incremental cost incurred by an issuer as a result of a particular electronic debit transaction and “other costs incurred by an issuer which are not specific to a particular electronic debit transaction.” An important part of the Board’s rule making will be to resolve which of the costs that lie between these two poles, “incremental costs” incurred with respect to the transaction and “other costs” not specific to the transaction, will also be considered allowable costs.

As noted above, the Act provides that the incremental costs incurred by an issuer as a result of a particular electronic debit transaction should be considered and that other costs which are not specific to a particular electronic debit transaction should not be considered. The Board will need to determine which of the costs that lie between these two end points should also be considered to be allowable costs. The FPC and the FERC have developed a number of rate-making principles that may be helpful to the Board in this process.

For those jurisdictional commodities and services for which it has not authorized sales at market-based rates, the FERC sets rates using a fully embedded, original cost model of cost-of-service rate making.<sup>12</sup> Under this model a utility’s revenue requirements “are comprised of its

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<sup>11</sup> “Pancaked” rates are, literally, the stacking of active rate cases. This entails a utility filing for approval of a new rate before one or more already pending rate increases has completed the trip through the regulatory process. In at least one recent instance, four subsequent rate applications have been filed for additional rate increases before the original rate increase application has been litigated to conclusion. Obviously, this leads to significant inefficiency for all involved.

<sup>12</sup> In his seminal work on public utility rate making, James Bonbright said, “one standard of reasonable rates can fairly be said to outrank all others in the importance attached to it by experts and public opinion alike – the standard

return on investment plus operating and maintenance expenses.”<sup>13</sup> The purpose of this methodology is to allow a utility the opportunity to recover its costs and a sufficient return on its capital investment to attract the capital necessary to continue operations. Any utility service that is badly undercapitalized or that requires subsidization from non-regulated operations will ultimately fail. The authority to use this approach stems from the Supreme Court case of *Commission v. Hope Natural Gas Co.* (“*Hope*”).<sup>14</sup> In that case, the Court described the methodology as:

The ratemaking process under the Act, *i.e.*, the fixing of “just and reasonable” rates, involves a balancing of the investor and the consumer interests. Thus, we stated in the *Natural Gas Pipeline Co.* case that “regulation does not insure that the business shall produce net revenues.” 315 U.S. p. 590. But, such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view, it is important that there be enough revenue not only for operating expenses, but also for the capital costs of the business. These include service on the debt and dividends on the stock. *Cf. Chicago & Grand Trunk R. Co. v. Wellman*, 143 U.S. 339, 345-346. By that standard, the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. *See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission*, 262 U.S. 276, 291 (Mr. Justice Brandeis concurring).<sup>15</sup>

This standard makes practical sense. The purpose for regulating rates is almost always a judgment that a product or service is so important to the economy that it should be available at a rate that is both affordable by those consuming the product or service and that ensures the

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of costs of service, often qualified by the stipulation that the relevant cost is necessary, true (*i.e.*, private and social) cost or cost reasonably or prudently incurred.” Bonbright, James C., Danielson, Albert L. and Kamerschen, David R., *Principles of Public Utility Rates*, 2<sup>nd</sup> Edition, Public Utilities Reports, Inc. (1988) at p. 109.

<sup>13</sup> *Energy Law and Transactions*, at § 3.03[1].

<sup>14</sup> *Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

<sup>15</sup> *Hope* at 320 U.S. 603.

continued availability of the product or service. Too high a rate will lead to excess costs to consumers of the product or service. Too low a rate will lead to a reduction in the supply of the product or service or even the unavailability of the product or service altogether. Clearly, a rate that destroys the economic viability of the product or service is contrary to the purpose of regulating the rate for the product or service to begin with. Even with these considerations in mind, the determination of the appropriate return on investment—along with the allowable, recoverable operating and maintenance expenses—is a complex and an often litigated subject in the rate-making process.

### **Separation of Regulated and Unregulated Services**

Finally, FERC practice supports the view that the costs that are specific to a transaction can be separated from other costs by appropriate allocation and, therefore, that regulated transaction prices should neither subsidize nor be subsidized by other, unregulated services under the Act.<sup>16</sup> In the context of interchange transaction fees, this would mean that those fees should neither subsidize nor be subsidized by other aspects of the deposit account relationship.

Cost of service rate-making normally recognizes actually incurred “operating and maintenance” expenses subject to several limiting principles:

1. Allocation. Operating and maintenance costs incurred partly to support regulated and partly to support unregulated activities different from the regulated activity for which a rate is being determined are apportioned between the multiple activities, and only that portion that is reasonably necessary to support the regulated activity for which a rate is being determined is included in the operating and maintenance costs for that rate determination. In the context of interchange transaction fees under the Act, this principle would mean that the general deposit account costs, such as statement costs, should be allocated between electronic debit card transactions and other transactions, such as check transactions.

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<sup>16</sup> FERC and most state commissions have established general rules as to which costs get allocated by the various methods of allocation. In general, costs can be allocated by multiple factors to include revenues, head count, square footage, or time.

2. Prudence. All expenditures of a regulated utility (including capital expenditures) must be consistent with what would be approved by a reasonably prudent, experienced utility manager based on the knowledge of the utility management at the time of the expenditure. Put another way, the expenditure must be reasonably necessary to the operation of the regulated activity. Certain activities may be viewed as unnecessary and consequently disallowed. Examples of this type of expenditure would be political or charitable donations and goodwill advertising campaigns (as distinguished from educational ads). In the context of interchange transaction fees under the Act, this principle would mean that costs must be reasonably required as part of maintaining debit card operations including costs associated with electronic debit transaction processing or the electronic debit transaction.
  
3. Normalization (sometimes also referred to as amortization). Costs for rate-making purposes are normally taken from a snapshot picture of some time span. FERC uses a base year followed by a 9-month test period for adjustments to the base year figure. Some costs are abnormal and others are “lumpy.” If an expense that occurred during the snapshot period is a one-time expense, it is usually eliminated since it need not be collected in rates established for future periods. Other costs may be periodic or cyclical, but may not necessarily take place every year. One example would be replacement of nuclear fuel rods, which may take place on a three-year cycle. Rate making would allocate one third of that cost to the rate year being examined to set a new rate. In the context of interchange transaction fees under the Act, this principle would mean that the cost of large capital investments, such as a data processing system, that are not incurred each year should be allocated over the life cycle of the system.

### **Rate of Return**

In addition Supreme Court precedent supports including a reasonable return on investment either as a cost or as part of the reasonable interchange transaction fee. The FERC uses the *Hope* principle in determining what constitutes a just and reasonable rate of return. The

FERC seeks to determine the just and reasonable return on equity by reference to returns on investments in other enterprises having corresponding, comparable risks.<sup>17</sup> It uses a Proxy Group of companies in the same or similar postures as the utility being examined. Each Proxy Group member is normally a regulated utility providing the same or similar services, is normally of roughly comparable size, has a similar risk profile as the company being examined, and has been publicly traded for at least long enough so that adequate financial information is publicly available for evaluation.

Once the Proxy Group has been determined, the FERC calculates the rates of return on equity for each of the Proxy Group utilities using a discounted cash flow (“DCF”) methodology. The respective rates of return for the various Proxy Group members are then considered to represent a range of reasonableness within which the utility in question’s rate of return should be established. (The FERC may determine that one or more of the Proxy Group members’ rate of return is so out of range with the others as to be inappropriate for inclusion.) FERC frequently picks the mid-point of the proxy range as the appropriate rate of return for the utility being examined, but on occasion will move toward the upper or lower limit based in its assessment of whether the utility being examined is relatively more or less risky than those in the Proxy Group. The courts have recognized the range of reasonableness, and have further indicated that the FERC can move the rate of return up within the range of reasonableness to support policy considerations not related to cost, such as incentives for investment in a certain kind of asset, as long as the rate of return ultimately remains within the zone of reasonableness.

Once the FERC has determined the appropriate rate of return on equity, that number is multiplied by the utility’s rate base to calculate the total revenue requirement. The rate base is, in simple terms, the utility’s net capital investment in assets dedicated to the regulated business<sup>18</sup> (and reasonable depreciation on those assets is an operating expense). Those assets that are in use to support the regulated business are allowed in the rate base. At FERC, this means, for instance, that the considerable capital cost of building a power plant is placed in the rate base when the plant is in service. This also means that the capital investment in any facility that is

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<sup>17</sup> *Proxy Group Policy Statement*, 123 FERC ¶ 61,048 (2008).

<sup>18</sup> The FERC makes a number of adjustments to rate base that are beyond this paper but may be worthy of consideration at the time that level of detail is under consideration.

dual or multiple use, *i.e.* being used to support regulated or unregulated activities different from the regulated activity for which a rate is being determined, must be appropriately apportioned between the multiple activities and that portion that is reasonably necessary to support the regulated activity for which a rate is being determined is included in the rate base for that rate determination.<sup>19</sup>

### **Conclusion**

When applied to the Board's rulemaking under the Act, the utility rate-making experience suggests that the Board adopt a full cost recovery model that includes an appropriate return on investment coupled with an approach to the setting of individual debit interchange rates that is flexible and avoids an adversarial process or micromanagement of individual rates and the burdens on both the regulator and regulated entity that such processes entail.

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<sup>19</sup> Another element of cost of capital that is recognized by FERC is the cost of debt. Normally, FERC will use actual cost of debt but, in some extraordinary circumstances, may look to the Proxy Group.