Save Money with Cost-Plus Pricing

Signing up for a new credit card merchant account? Renewing an old one? You can save a substantial amount of money by making sure you get a favorable pricing structure.

"There has been a sea change in pricing in the last two years," says Bill Hearon, president of Effective Payment Management, a consulting firm in Princeton, N.J. "Much of the industry has gone from multitiered pricing to cost-plus pricing. Businesses need to be sure they are getting the latter."

Pricing: Tiered vs. Cost-Plus

When negotiating a good deal on a merchant account, you can't do much about the interchange costs that are actually paid to the banks. But you can look for a good deal on the "markup," or what your merchant service provider or independent sales organization (ISO) charges you for processing payments.

Under the traditional tiered pricing system, all of the interchange categories are jammed into one of a limited number of pricing levels. There are typically three to five levels, similar to the following:

- ***Tier one: Qualified.*** *These are transactions where the card is present and swiped. They get the best rate.*
- ***Tier two: Mid-Qualified.*** *These are primarily "card present" transactions where the credit card numbers need to be keyed in because the card could not be read properly by the terminal. These get a middle rate.*
- ***Tier three: Nonqualified.*** *These consist of other transactions, such as corporate cards, that need to gather additional information, such as the code of the customer and the tax amount. These get the worst rate.*

In many programs, all credit card transactions, regardless of their actual interchange costs, are fitted into one of these three presets. For example, debit/check card transactions are often placed in the qualified tier, even though the debit/check card interchange cost is much less. Another example is rewards card transactions, which may be placed in the mid-qualified tier or the nonqualified tier. This can result in the retailer paying from three to eight times more than would be appropriate, given the interchange costs for such cards.

Some processors include two additional categories for debit and rewards cards. Even then, scores of additional transaction categories are unfairly slotted into one of the presets.

In contrast, the cost-plus system marks up the actual interchange rate by a given amount for each transaction. The markup typically ranges from 0.15 percent to 0.75 percent.

How much can this save? According to Hearon, the shift from tiered to cost-plus pricing is reducing the cost of accepting credit cards for many merchants overall from 15 percent to 35 percent.

Hearon offers an example: Suppose a customer presents a corporate card. The bank might charge an interchange rate of 2.32 percent for the transaction. Dues and assessments of 0.095 percent might bring this to 2.415 percent. In a cost-plus system the retailer would pay perhaps 2.565 percent to 3.165 percent. Under the tiered system the transaction would be lumped into the nonqualified tier where the merchant might be charged 3.50 percent. In this example, the cost reduction would range from close to 10 percent to over 25 percent.

MERCHANT ACCOUNTS:

Getting the *Best* Credit Card Contract

by Phillip M. Perry

If you're like most retailers, you know that credit cards are as vital to your success as great merchandise and a sparkling sales pitch. Turn your back on credit cards? Forget it. Disappointed shoppers would do the same to your store.

Each time a customer uses a card at your register, the processing company takes a cut from the sale. And therein lies the problem: Many times the charge is far higher than it need be. The amount depends on the agreement you have with the independent sales organization (ISO) that handles your merchant account.

"Some ISOs have integrity but some are charlatans," warns Bill Hearon, president, Effective Payment Management, a consulting firm in Princeton, N.J. Signing with the wrong one can mean excess fees that take a real bite from your bottom line.

Read Your Contract

How can you weed out the bad ISOs from the good? And how can you get the best deal when you arrange for a new merchant account or renew an old one? The answers lie in a careful reading of your contract.

If you've neglected your merchant account agreement, you're not alone. Most retailers don't read their contracts, says Bob Becker, a Pittsburgh-based consultant who specializes in merchant services processing programs. And little wonder: The documents are confusing. The good news, though, is that it is possible to cut through the arcane terminology.

Here's some guidance on doing just that. Dust off your merchant account contract and ask these questions:

Question #1: Is the early termination fee reasonable?

Most merchant service contracts call for a minimum term, typically three years. But what happens if you want to cancel the contract early? Maybe you're unhappy with the service you're getting. Maybe the vendor hasn't been answering your emails or returning your phone calls. Or maybe you've just found another vendor with a better rate.

You may be surprised that you face a financial penalty if you drop out early. "It is often not explained to merchants that they will incur an early termination fee if they cancel before the end of their contractual term," says Becker. Very often, this detail is buried in the fine print, along with the actual amount of the penalty.

Reasonable termination fees make sense. "The processor incurs expenses setting up a new merchant account, and that should be covered by the early termination fee," notes Becker. Unfortunately, in many cases the fees are excessive. "The amount should not be ridiculous; $250 or $300 is reasonable. But I have seen contracts that call for $1,000 or more."

In the worst cases, termination fees can be crippling. "The contract may state that the merchant is required to reimburse the processor for 'x' months of lost profits if the contract is broken early," warns Paul A. Rianda, an Irvine, Calif.–based attorney specializing in the bankcard industry. "This can amount to thousands of dollars."

Question #2: Are transaction fees fully disclosed?

A provider may lure you in with a promise of a low transaction fee of perhaps 1.6 percent. Only later do you discover that much higher rates will apply to anything more than the common "card present" transactions. For example, the fee to take an order over the phone and without address verification may be exorbitant.

Think about what categories of transactions your own operation encounters beyond the common customer- and card-present ones. Then make sure you receive full disclosure about the fees for those transactions. "Different pricing structures suit different merchants," says Bryan Johnson, CEO of Braintree Payment Solutions, an electronic payment processing company based in Chicago. "Be aware of what the rate levels are and what cards apply to them."

Question #3: Are you on a cost-plus fee schedule?

Are you getting the best deal when it comes to transaction fees? The trend today is toward "cost plus" pricing, which calls for a specific markup on the actual transaction fees charged by the banks to the processors. This is a major shift from the traditional multitiered pricing, the norm in retailing for decades, which lumped all transactions into a few presets such as "qualified," "mid-qualified," and "nonqualified."

You can save considerable amounts of money by shifting to a cost-plus system. "Cost-plus can result in savings of some $2,000 annually for a merchant who does $30,000 to $50,000 in credit card sales," says Becker.

How to do it? For more information, see the sidebar "Save Money with Cost-Plus Pricing" on the preceding page.

Question #4: Are you paying a reasonable fee for equipment?

Although equipment leasing has long been a traditional piece of the credit card processing puzzle, it is seldom necessary. You will save money by purchasing your terminal outright.

"Many merchants go ahead and lease their equipment because

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Beware Excess Chargebacks

Many merchants are not aware of the financial consequences of excess chargebacks, notes Paul A. Rianda, an Irvine, Calif.–based attorney specializing in the bankcard industry. He says the credit card industry has a 1 percent threshold under most circumstances for chargebacks. If you have 100 transactions a month, for example, then your threshold would be one chargeback. "Any more than that and the processor may decide to hold all of the funds in your account for up to six months, as a defensive measure against excessive future chargebacks," Rianda says.

The way to avoid this is to maintain a liberal refund policy. Before granting a chargeback, the credit card companies assure themselves that the complaining customer has tried to work out the problem with the merchant.

Get More Information

Merchant Processing 101, by Robert Becker. A tutorial that helps you determine if you are getting the best deal on your merchant account. $28.96. Available at www.merchantprocessing101.com.

Effective Payment Management, a Princeton, N.J.,-based consulting firm, offers a series of online articles on how to shop smart for a merchant account: www.effectivepaymentmanagement.com.

Braintree Payment Solutions, a Chicago-based payment processor, provides information online about what to look for in a good contract: www.braintreepaymentsolutions.com

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they figure the $25 or $30 monthly fee is not that much," notes Becker. "But that can add up to over $1,000 in a 36-month contract." In contrast, purchasing the same equipment may cost you from $250 to $400.

Question #5: Does your processor have the right to increase fees at any time?

Does the contract allow your ISO to increase transaction fees at any time? Many of them do. The problem is the open-ended nature of these increases.

Your ISO usually increases your rate in response to an increase from the credit card processor. That increase, in turn, occurs in response to an increase in the issuing bank's interchange rate, which is the percentage the bank receives for each credit card transaction.

You might expect that the increase you incur would be a simple pass-through. Unfortunately, many providers look at these increases as opportunities to raise their own margins without the merchant knowing. "The majority of merchants don't review their monthly processing statements because the documents are in a nearly illegible format," notes Johnson. "So when interchange rates go up, it's easy for providers to tack on additional margin."

Here's a related question: Does your contract give the processor the right to add additional fees? That can be too one-sided. Becker advises that the contract should state that the processor will not raise fees for any reason other than an increase in the interchange rate that is paid to the banks. These interchange rate increases usually take place once a year in the spring. If the processor wants to increase rates beyond what the associations are charging, then the merchant should have the option of canceling the contract without penalty.

Due Diligence

Unrealistic termination fees, bloated transaction fees, and excessive equipment charges are hidden land mines in merchant account contracts. Take care to spot them.

And what if you don't like your contract? Can you negotiate a better deal?

"Smaller merchants usually do not have the leverage to make changes in a merchant account contract," says attorney Rianda. "The best thing to do if you don't like a provision in a contract is to find another processor."