

## INTRODUCTION

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**5.1** This chapter sets out the proposed scope of the new regime, details of the rules which will apply to those within its scope and how these rules can be modified. The Government is keen to consult on what it is seeking to achieve rather than on the precise definition of the scope of the regime and the wording of individual rules – these issues can be considered in due course when the Government brings forth its legislative proposals.

## SCOPE OF REGIME

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**5.2** The Cruickshank report suggested that the new framework should encompass all participants in payment systems:

**3.187** In order to define the scope of this licensing regime, ‘payment system’ should be given a legal definition. For example, the recent Australian legislation defines a payment system as a ‘funds transfer system which facilitates the circulation of money’. Participation in a payment system should be defined widely to include suppliers of payment services to end users (such as banks), payment schemes, scheme or service administrators, infrastructure operators, and end users.

**5.3** In looking to define the scope of the new regime there are a number of possible options such as covering payment schemes, payment systems or payment services. However, there is not necessarily a commonly accepted definition of what each of these terms mean. The phrase ‘scheme’ is usually used to define the overall set of rules surrounding a particular payment method or set of payment methods. Examples of UK schemes include LINK, Switch and BACS. The phrase ‘services’ is generally used to refer to the provision of individual payment methods to end user consumers and businesses. A number of different services might be provided under a single scheme. For example, standing orders, direct debits and direct credits are all provided under BACS. The phrase ‘payment system’ is used in this document to describe the overall process by which one end user (a consumer or a business) transfers funds to another end user. It includes the physical apparatus used to provide payment services – both common infrastructure owned jointly by a scheme’s members and infrastructure (such as banks’ own internal IT systems) owned by an individual payment provider, who may or may not be a direct member of the scheme.

**5.4** As payment systems evolve it is likely there will be a variety of payments system structures involving a range of different parties. One trend which may develop is demutualisation where the members of a payment scheme sell off the common infrastructure and central systems used by the scheme to a third party, such as a technology company. The scheme members then contract with this company for the provision of services. In such circumstances, it no longer makes sense to refer to the scheme as being the same thing as the payment system. It is possible that a single infrastructure could be used to support a range of payment schemes and payment methods. A more detailed description of payment systems is set out in Annex 1.

**5.5** This means that there can be a wide range of participants in payment systems:

- scheme administrators who may or may not run common infrastructure;
- infrastructure owners;

- payment providers;
- end users who may provide their own point of sale terminal equipment; and
- intermediary service providers.

**5.6** It would seem inappropriate to define the scope of the new regime in relation to any one particular type of participant. For example, a regime which only applied to schemes would fail to catch payment arrangements where there was no common infrastructure and instead there was a series of bilateral arrangements between different providers. Whilst bilateral arrangements may not be common in the UK at the moment, there is no reason why they could not become so in the future.

**5.7** In designing a new regime, the Government's intention is that the scope of the regime should encompass those participants who could potentially abuse their market power so as to frustrate competition or hold back the development of a payment system. All of the participants listed above could potentially act as a bottleneck in the provision of payment services and could therefore potentially possess market power. For example, it is not inconceivable that in a few years' time there could be a single monopoly infrastructure provider for a number of different payment systems in the UK. However, such a provider would not necessarily be a provider of payment services to end users so a definition of scope dependent on the provision of payment services could fail to catch all relevant parties.

**5.8** Consequently, none of the main candidates – payment scheme, provider of payment services and payment infrastructure provider – would seem to be suitable cases for defining the persons who are subject to the new regime, if it is to be flexible enough to cope with all eventualities. Given that the Government is seeking to open up access to payment systems to non-banks (where appropriate), and given the difficulties surrounding the use of 'scheme', 'service' or 'system', a definition based around the concept of 'participation' in the provision of payment services would seem a sensible approach. This then raises the question of how 'participation' or 'participant' would be defined. The Cruickshank report suggested that 'participation' should be defined widely to include suppliers of payment services to end users, payment schemes, scheme or service administrators, infrastructure operators, and end users. The Government would welcome views on this.

*Q14. Which participants in the provision of payment services should be subject to the new regime? In particular, is it appropriate to include those end users who control access to point of sale terminal equipment?*

**5.9** In addition to the question of which participants in the provision of payment services should be subject to the new regime, there is the question of what is to count as a payment service for this purpose. At first sight, it might seem that a simple definition of 'transfer of funds' or 'exchange of money' might suffice. However, some payment methods, such as cheques, are based more on a promise to pay than on an actual exchange of money. Consequently a definition which captures the concept of facilitating the circulation of money or the transfer of funds would seem more appropriate. The Government would welcome views on this.

*Q15. Should the aim in defining a payment service be to include those services which have a primary purpose of facilitating the circulation of money or the transfer of funds?*

**5.10** The final issue in defining the scope of the new regime is its geographical scope. Many payment schemes are not confined to the UK but are European or global in scope. With the introduction of the Internet and e-commerce it may even become difficult to define where a

particular payment system is based. This issue is not unique to payment services; it was raised, for example, in the context of the provision of financial services and the Financial Services and Markets Act. The Government's objective is to ensure that there is a level playing field in terms of participation in the UK in the provision of payment services and therefore it intends to define the geographical scope in terms of participation in the UK in the provision of payment services (even if those services are provided by an infrastructure that is principally based outside the UK).

## Exclusion of certain payment services

**5.11** The objective of the new regime is to tackle competition problems associated with the provision of payment services to end users. This raises the question as to whether payment systems which are not used to provide services to end users (such as consumers and businesses) should be included in the scope of the regime. Examples of such systems would include those which are only used for trading purposes – such as foreign exchange or securities settlement. The parties to such systems are generally large corporate entities that have sufficient resources and market power to look after their own interests. It would seem that there may be merits in excluding from the proposed regime those payment systems which are not used to provide services to end users. The Government would welcome views on this.

*Q16. Should systems which are not used to provide retail payment services to end users be excluded from the scope of the new regime?*

**5.12** Another issue is whether the regime should apply to one-way payment services that are used to pay a limited number of recipients. Examples of these include PayPoint for utility bills or MoneyGram and Western Union which are generally used to make cash payments abroad for those who do not have access to bank accounts. Any exclusion would need to be carefully defined to ensure loopholes were not inadvertently created. One possible option would be to apply the regime only to general purpose payment systems, or applying it only to bi-directional payment systems. Such exclusions could also ensure that others involved in the circulation of money, such as bureaux de change, were not inadvertently included within the regime. However, as explained below, apart from price transparency requirements, it is intended that the rules will only apply where participants have a significant degree of market power. It might be argued that on such a basis schemes which did not have the potential to distort competition materially would automatically be excluded. The Government would welcome views on this.

*Q17. Is there a need to exclude explicitly payment systems which are used to pay a limited number of recipients?*

## RULES AND THEIR MODIFICATION

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**5.13** The Cruickshank report envisaged a set of regulatory rules, albeit licence conditions, which would apply to all participants in the provision of payment services and dealing with:

- price transparency;
- efficient wholesale pricing;
- non-discriminatory access;
- good governance; and
- fair trading.

**5.14** It envisaged that these rules would be based on general prohibitions or requirements which would be supplemented by detailed guidance from the OFT on how they would be applied and enforced in practice. This is a similar approach to that adopted with the Competition Act 1998. The OFT has a duty under s.52 of that Act to prepare and publish general advice and information about the application of the Chapter I & II prohibitions. The advantage of adopting such an approach is that it retains a degree of flexibility for the future – guidance can be updated in light of market developments rather than there being a need for formal rule modifications. However, as the Competition Act guidelines themselves make clear, guidance is not a substitute for legislation, regulations or orders.

**5.15** The use of general provisions also means that there can be a level playing field with a single set of simple rules which, provided certain threshold criteria are met, can be applied to all participants in the provision of payment services. Such an approach would meet the criteria of competitive neutrality, proportionality, transparency and flexibility set out in Chapter Four above. Whilst it is intended there will initially be a single set of rules, the Government proposes to ensure that it would be possible for certain rules to apply only to certain categories of participants.

**5.16** The Cruickshank report recommended that the original set of rules should be written by the Treasury. The Government accepts this is appropriate in bringing forward the new framework. Draft rules should be available when legislation is taken through Parliament for the information of both Houses and of those affected by them. These rules would be subject to Parliamentary procedure once the primary legislation came into force. The power to make rules would be a one-off power for the Treasury and would be replaced with a power for the OFT to propose modifications to the rules. If participants did not oppose the modifications, following widespread consultation, then the OFT would be able to use rule making powers to put the new rules in place. As referred to above, it is proposed that any proposals from the OFT to modify the rules would need to be accompanied by a cost-benefit analysis.

**5.17** If there are objections to the modifications then the Government proposes that the proposed rules should be referred to the reporting arm of the Competition Commission for investigation (in the same way that licence modification references are made in the utilities sector). However, the issue arises as to which parties should have a veto on the rule modification going ahead without there being a Competition Commission reference. If certain rules applied only to certain categories of participants, then should only participants in those categories have a right to object to a change to those rules without reference to the Competition Commission? And as any rule is likely to affect a number of participants, should every participant affected by a proposed change have such a right?

**5.18** This issue has been addressed in the utility sector. The Utilities Act 2000 introduced a new procedure for licence modifications for gas and electricity companies. It allows the regulator to proceed with licence modifications, even if there are objections from those directly affected, on either of two grounds:

- the licence modification is deregulatory in that it would remove or reduce the burden without removing any necessary protection; or
- where the proportion of the relevant licence holders, both in absolute terms and by market share, who have given notice of objection is less than a prescribed percentage.

**5.19** The Government sees merits in adopting a similar approach in relation to rule modifications although it recognises that unlike the utility sectors, without a licensing regime for payment systems, there will not be a list of authorised payment service providers. The Government would welcome views on the issue.

*Q18. In what circumstances should the OFT be able to proceed with rule modifications without the consent of those subject to those rules?*

## Threshold for intervention

**5.20** The Cruickshank report suggested that whilst price transparency requirements should apply to all participants, the other rules should only apply to those with significant market power:

**3.189** The class licence would include a number of further conditions for participants who enjoy significant market power in the supply of payment services, whether as schemes, banks or infrastructure providers. The test of market power is an economic one: is the participant able adversely to affect the overall level of prices, service quality or innovation in the supply of payment services to end users? This falls short of the test required to prove dominance under European competition law. More than one participant in a relevant economic market may enjoy significant market power.

**3.190** The licence conditions applying to participants with significant market power would aim to overcome the problems identified in this chapter, and especially poor governance, distorted wholesale pricing and anticompetitive retail pricing. The regime should concentrate on the economic effects of particular behaviour, rather than the particular form that such behaviour takes. In particular, it must not be possible for individual banks or groups of banks to avoid the licensing regime by taking unilateral or bilateral actions that replicate anticompetitive restrictions currently imposed by payment schemes.

**5.21** The concept of using different thresholds of market power for imposing different remedies is not a new idea. It is acknowledged under UK competition law, for example, where the Chapter I prohibition applies when there is an 'appreciable effect' on competition in the UK whilst the Chapter II prohibition applies where an undertaking has a 'dominant position' in a market.

**5.22** The Government accepts the report's recommendation that the threshold for intervention under the new regime should be lower than that required to prove dominance under general UK and European competition law. This would be consistent with the approach taken to sector-specific regulation in the UK where there is not generally a requirement to establish dominance before rules come into effect. However, it would be disproportionate for all rules to apply automatically to all participants in the provision of payment services and for there to be no threshold test.

**5.23** The Government therefore agrees that there should be a threshold test and it should be one based on economic concepts of market power. Nonetheless, the Government is concerned that the use of the specific term 'significant market power' might be confused with its use in other areas. The phrase was introduced in the context of the regulation of telecommunications networks and is not necessarily applicable in the same way in the context of payment systems.

**5.24** An alternative would be to introduce an effects-based test and for rules to apply only where there was a material effect on competition. This is analogous to the market power threshold under the Chapter I prohibition of the Competition Act which, as described above, applies where there is an ‘appreciable effect’ on competition. It is only firms which have market power who are judged as capable of having an appreciable effect on competition. If a material effects-based test were introduced, the OFT would be expected to issue detailed guidance on its approach to applying such a threshold test in practice. The Government would welcome views on this or on alternative approaches to defining the threshold for application of the rules. In doing so, the Government is keen to avoid any uncertainty over how the proposed rules and the Competition Act will interface with each other.

*Q19. Should the threshold for the application of the rules, apart from price transparency, be one based on the concept of material effect on competition? If so, what should constitute materiality?*

## Price transparency

**5.25** The Cruickshank report suggested that there should be a licence condition imposing price transparency requirements on all participants irrespective of whether they had significant market power:

**3.191** For competition in retail markets to work effectively, customers must know the price they are paying for goods and services. Clear price information is also a basic consumer right. The standards of price transparency in some payment systems are currently unacceptable. The class licence should therefore require that all participants who offer payment services to personal and SME customers to provide timely, accurate and relevant price information.

**5.26** The Government accepts that clear price information is a basic consumer right. In looking at what price information should be provided, it seems clear that the requirement should encompass not just the charges themselves but also other charges that are directly associated with the provision of the payment service. So, for example, not only would the costs of writing or paying in cheques need to be specified, but so would any charges for bounced cheques. It is not clear however, that the costs associated with the provision of credit, such as credit card interest rates or overdraft interest rates, should be included. The Government would welcome views on this.

*Q20. Should the requirements for price transparency extend not just to charges for payment services themselves but to other charges that are directly associated with the provision of the payment service?*

**5.27** In imposing price transparency requirements, there is a practical issue of how detailed the rule should be in specifying the prices which have to be published. To try to specify detailed requirements in the rule would risk inflexibility. It would appear to be impractical and disproportionate to have to embark on a rule modification process to cope with the introduction, for example, of a new charging method or a new retail service. The Government therefore proposes that the rule would require all participants who provide payments services to end users to promote price transparency by providing their customers on a regular basis with details of the direct charges for all payment services and other charges that are directly associated with the provision of those services. The Government would welcome views on this.

*Q21. Should the rule on price transparency be aimed at requiring the promotion of price transparency by requiring the provision on a regular basis of the details of charges for all payment services and other charges that are directly associated with the provision of those services?*

**5.28** The OFT would be required to publish guidance on how this rule should be complied with in practice. An alternative to the OFT specifying the detailed requirements would be for the industry to set these out in a code which would be subject to the approval of the OFT. There could then be a fallback power for the OFT to specify the requirements in the event of disagreement or where the industry failed to produce a code. The Government would welcome views on this.

*Q22. Should the OFT be given the power to approve an industry code which could set out detailed price publication requirements?*

### Publication of retail prices

**5.29** The Cruickshank report did not recommend that rules should be put in place to regulate retail prices, suggesting implicitly that price transparency should be sufficient to ensure consumers are protected. Whilst the Government accepts that price regulation may be a very interventionist approach, it is legitimate to question whether the benefits of solving the competition problems of the underlying payment networks will inevitably feed through to benefits for consumers at the retail level.

**5.30** The Consumers' Association has suggested that no assumption should be made that there is an automatic link between a fairer, less discriminatory and more transparent money transmission system and a fairer, less discriminatory and more transparent retail financial system. It believes that the nature of this link is probably more important to consumers than the effectiveness of a regulator in enforcing an effectively competitive transmission system. It therefore suggested the following measures to strengthen consumer protection in this area:

1. Establish PayCom with the remit identified.
2. Supplement the remit with a data collection and transparency provision to ensure that the following data are made public;
  - (a) all data related to the operation of the transmission system
  - (b) a financial service supplier specific data set to indicate the relationship between their charges and performance within the transmission system and the charges and performance that they offer to their retail and business customers
  - (c) The 'relationship dataset' to be publicly available on a monthly basis and posted on the Internet and in press releases.
3. Establish a joint PayCom/FSA working group to identify if any regulatory responses are necessary to more closely tie transmission charges and performance measures to retail ones.

The publication of the 'relationship dataset' would indicate the link between the transmission system and the charging and performance offering in the retail financial market. This, in and of itself, would provide a degree of transparency in the marketplace that would hopefully encourage financial services providers to ever better performance levels.

**5.31** The Government believes there would be benefits to consumers if comparative information on retail prices was more readily available. It does not believe that a statutory duty for the OFT to publish such information is necessarily the best way to achieve this, though. Such a duty could stifle innovation by businesses or result in unnecessary duplication if, in time, the private sector or other bodies such as the FSA start disseminating such information. The Government believes it would be better to give the OFT a power to collect

and publish the terms and conditions, including prices, of retail payment services. This would allow the OFT to decide whether it was necessary for it to publish the information itself. The Government would be interested in the views of others:

*Q23. Should the OFT have a power, but not a duty, to collect and publish the terms and conditions, including prices, of retail payment services?*

## Publication of wholesale prices

**5.32** The Consumers Association also suggested that details of the wholesale charges of the underlying payment networks used to provide retail payment services should be published. From the point of view of promoting effective competition, price publication can have both advantages and disadvantages. In certain circumstances, price publication can actually facilitate price fixing or price collusion between market participants rather than acting as a spur to promote price competition. However, in today's payments markets, with its cross governance arrangements, market participants already often have a very clear idea of the charges associated with competing schemes or competing participants.

**5.33** In looking at the prices for indirect access to APACS clearings, the Cruickshank report found:

**3.93** ...the market is highly concentrated in the hands of the big four clearers and the two largest Scottish banks. The very wide range of prices charged – a factor of ten in some cases – suggests that smaller and less well informed customers may be paying over the odds for access. And certain aspects of the service are not open to negotiation. These factors suggest that competition is less than perfect.

**5.34** There would therefore seem to be some advantages to wholesale pricing information being published. In relation to interchange fees, the European Commission has required greater price transparency as a condition of clearing agreements. For example, in the case of payment systems which are dominant the Commission has imposed certain conditions for exemption including that there should be transparency as to the level and existence of interchange fees for the payment system's customers.

**5.35** The Australian Consumer and Competition Commission and Reserve Bank has also commented on the lack of transparency in its recent report on interchange fees<sup>1</sup>:

...Some fees and charges are very transparent and it is relatively easy to make choices based on them. Others are not transparent, but may be just as important in influencing which payment instrument is used and what the resulting cost to the economy is. Interchange fees are an example of the latter. Interchange fees are 'wholesale' fees, which are paid between financial institutions when customers of one institution are provided with card services by another financial institution. Customers do not see these fees directly but the fees affect the incentives they face.

**5.36** Unlike retail prices, there would not seem to be benefits in directly providing personal customers with information on wholesale prices. It is questionable how many of them would be in a position to understand this information in isolation and it may therefore be preferable to require the OFT to publish that information. It would be in a position to do this on a comparative basis between different suppliers. In deciding whether to publish information on wholesale prices or information on the process by which wholesale prices are set the OFT

<sup>1</sup> RBA/ACCC *Debit and credit card schemes in Australia: A study of interchange fees and access* October 2000.

would be able to make a judgement on whether the benefits of such publication outweighed the costs in the context of promoting effective competition for the benefit of consumers. The Government would welcome views on this.

*Q24. Should the OFT be required to publish information on wholesale prices and/or how those prices are set where that would promote effective competition for the benefit of consumers?*

## Efficient wholesale pricing

**5.37** The Cruickshank report specifically addressed the issue of wholesale pricing:

**3.198** Wholesale prices in payment schemes are often set to further the interests of controlling banks rather than to reflect underlying costs. The process by which they are set is neither competitive nor transparent. Wholesale prices directly influence the prospects of entry into customer facing markets and the prices that customers and businesses pay for payment services. The economic consequences of distorted wholesale prices include higher prices, lower levels of innovation and slower development of e-commerce.

**3.199** The class licence should therefore ensure that any wholesale prices – including interchange fees – that are wholly or largely determined by a payment scheme with significant market power should be derived through a process that is transparent to final users. Such prices should be based on legitimate costs and should anticipate achievable cost reductions.

**5.38** The Government has examined the report's conclusion that wholesale prices, including interchange, should be cost based. There are respectable economic arguments in favour of suggesting that interchange fees should be set not to reflect costs but to balance the costs between issuers and acquirers with a view to maximising overall demand for the payment scheme. However, for established payment systems it would appear that there are more damaging effects associated with a high, non-cost-based interchange rate than with a lower, cost-based interchange rate. The Cruickshank report identified a number of detrimental effects of inflated interchange rates including:

- high costs for retailers which in turn lead to higher costs for consumers;
- weakened incentives for issuers to cut costs through greater efficiency; and
- competition between payment mechanisms being distorted in favour of products with artificially high interchange fees (when those interchange fees are used to fund loyalty schemes).

**5.39** The concept of forward-looking prices for established payment systems is that reductions in costs including improvements in efficiency get passed on to end users. It has been used in the context of regulating telecommunications networks in relation to interconnection prices where there is a requirement for cost orientated prices which means that prices must be reasonably derived from the costs of providing the service based on a forward looking incremental cost approach<sup>2</sup>. Issues which would need to be considered include the time period over which costs should be calculated, future development costs which should be taken into account and the need to maintain incentives to invest. The emphasis on forward-looking costs echoes, to some extent, requirements that the European

<sup>2</sup> Condition 47 Licence to be Granted by the Secretary of State for Trade and Industry to British Telecommunications under Section 7 of the Telecommunications Act 1984 15 September 1999.

Commission has imposed on certain interchange fees in the past, namely that interchange fees should be set in an objective manner and be revised regularly. The Government believes it would be appropriate to introduce a rule to promote efficient wholesale pricing.

*Q25. Should the rule dealing with efficient wholesale pricing be aimed at requiring wholesale charges:*

*– to be derived through a published methodology based on legitimate costs*

*– to anticipate achievable cost reductions*

*where a failure to set prices on such a basis would have a material effect on competition?*

**5.40** There is obviously an overlap between this proposed rule and the suggestions in the previous section that the OFT could be required to publish details of wholesale prices and how they are derived. The two approaches are complementary. With the proposed rule, the onus would be on the providers of payment services to ensure there is a published, cost-based methodology. The OFT could seek to complement that information with an analysis of its own explaining the relationships between that methodology, the wholesale charges and end user retail prices. Also, the rule goes further than price publication in that it would enable the OFT to investigate whether wholesale charges were cost based. If it found they were not, it would be able to make an enforcement decision aimed at requiring the introduction of a proper cost-based methodology for setting prices. Issues about the actual levels of prices and whether they are non-discriminatory should be capable of being addressed through the proposed rule on non-discriminatory access described below.

## Non-discriminatory access

**5.41** The Cruickshank report made the following comments about access:

**3.196** Another fundamental problem is the restrictions on direct access to payment schemes. These hamper competition in the markets facing customers and businesses, resulting in higher prices and lower levels of innovation. Widening access to payment schemes will bring in new suppliers and fresh ideas and will help to provide a payment system for e-commerce. Access conditions for payment schemes may still be tough, given the risks involved, but must be based on explicit criteria that directly reflect these risks. For example, participants may be required to prove that they have a sufficiently high credit rating, or that they have adequate safeguards in place to control operational risk. Access conditions should not be permitted which artificially limit access to a payment scheme to particular classes of firms, such as banks or card issuers.

**3.197** The class licence should therefore contain a condition which requires that access to payment schemes with significant market power and any infrastructure they control must be non discriminatory.

**5.42** In requiring access, the central issue is on what terms should access be required. Issues of 'fairness' are never easy to judge. However, non-discrimination on its own may not be sufficient to tackle the competition concerns. There is a danger that a supplier, particularly one which is vertically integrated, would be happy to impose onerous upstream wholesale prices on its downstream retail arm if it meant its smaller competitors would also have to meet those onerous prices. Being vertically integrated, it would have sufficient profits from its upstream wholesale activities to subsidise the provision of its downstream retail services. The concept of reasonableness (or proportionality) is therefore important and would need to include consideration of any material adverse effects on financial stability. The Government would welcome views on this.

*Q26. Should the rule dealing with non-discriminatory access be aimed at requiring participants to provide access on fair, reasonable and non-discriminatory terms where failure to provide access would have a material effect on competition?*

**5.43** It will be important to ensure that non-discrimination in providing access encompasses all the terms of access including both prices and the criteria for access (such as those dealing with security and technical issues). Some interested parties have suggested that a requirement for open access would stifle innovation and allow free riding. However, it is envisaged that the OFT would only be able to require access where a failure to do so would have a material effect on competition, and not have a material adverse effect on financial stability. This would allow new, innovative systems to restrict access (ie be exclusive) whilst they were in the process of establishing critical mass. The OFT would also need to make clear in the guidance it publishes the sort of pricing structures that would be considered reasonable. In other words, the guidance would need to address the need for prices to include the cost of capital to allow existing participants to make a fair return on their investment and how sunk costs should be treated. The guidance would also need to address the risks associated with opening up access to payment systems. In other words, that risk based criteria were appropriate in ensuring the smooth running of payment systems but that such criteria would need to be proportionate and minimise adverse effects on competition.

## Good governance

**5.44** The Cruickshank report stated:

**3.192** The second area to be addressed is the way in which committees of bankers own and operate all the major payment schemes. This stifles innovation and change, provides incentives for anticompetitive behaviour and has resulted in a system that cannot cope well with the demands of the new internet age. What is needed are governance structures designed to meet the needs of users rather than suppliers.

**3.193** The approach taken by the Canadian government has been to regulate directly the board structure of the Canadian Payments Authority, their equivalent of APACS. A more flexible approach would be to apply a simple rule to payment schemes where significant market power is present, and allow schemes to experiment with different corporate structures.

**3.194** The class licence should contain a condition which prohibits a firm – or group of firms – with significant market power from controlling a scheme which likewise exerts significant market power. Control of a scheme by a firm can be defined as the power to ensure that the scheme's affairs are run in line with that firm's wishes, whether by means of shareholding, voting rights or other powers. [As for example in the Income and Corporation Taxes Act, 1988, section 840.]

**3.195** Prohibiting such control of a scheme with significant market power would still allow a range of governance models. These might range from running schemes as arms length for profit companies to wider stakeholder models in which a range of users jointly govern a scheme.

**5.45** A number of interested parties have suggested that a rule along the lines suggested by the Cruickshank report would be too intrusive and would be difficult to apply in practice. If, as is generally the case, no single firm is in a position to control a payment scheme, it would be difficult to determine the group of firms that is capable of exercising control collectively and therefore which firms should be prohibited from exercising control. It has also been suggested that prohibiting control could dull incentives to invest or incentives to participate in payment schemes. The Government shares some of these concerns.

**5.46** Some of the concerns which the Cruickshank report identified as stemming from the governance problems – anti-competitive restrictions on access, anti-competitive and inefficient wholesale pricing and poor transparency – are capable of being addressed under the specific rules dealing with these issues. However, others, particularly those to do with the lack of inter-system competition, are unlikely to be dealt with by such rules.

**5.47** One approach would be to rely primarily on structural reforms – for example, requiring payments systems to be run at arm’s length from the banks or other institutions which own and use them. This could follow the model being applied in the electricity sector, where the old Regional Electricity Companies are being required to establish an arm’s length relationship between their supply and distribution activities, where this has not already taken place. There is already full legal and ownership separation in gas between the network operator, Transco, and gas shippers and suppliers. The main advantage of such an approach is that it removes the incentives which lead to the sort of abuses which the Government wishes to tackle, and therefore should require less regulation in the long term. However, it would clearly be more interventionist in the short term. The Government believes that structural reforms are not justified at this stage, although such remedies are available under the monopoly provisions of the Fair Trading Act 1973 if other measures prove ineffective.

**5.48** An alternative to the structural solutions of the sort proposed by the Cruickshank report is the use of behavioural remedies. One possible solution would be to prohibit abuse of control rather than the control itself. This has the added attraction of being a more effects-based approach. It should be clearer to see who is exercising control in the context of a particular decision. So if a scheme were deciding whether to compete against another scheme, the voting record should clearly show which members, individually or collectively, prevented competition from going ahead. The Government would welcome views on this.

*Q27. Should the rule dealing with good governance be aimed at prohibiting the abuse of control, either individually or collectively, of a payment scheme where there was a material effect on competition rather than at preventing control altogether?*

## Fair trading

**5.49** The last licence condition recommended in the Cruickshank report was a more general condition dealing with fair trading:

**3.200** More effective regulation of payment schemes could induce larger suppliers to retrench into bilateral agreements between themselves. They may also be able to recreate similar entry restrictions through their own individual activities, for example by charging high and discriminatory fees for using their ATMs. These would be bad outcomes in terms of efficiency and competition. To prevent this, further powers are needed to deal with this potential problem.

**3.201** The class licence should ensure that those suppliers of payment services who have significant market power are not able to withhold cooperation unreasonably from payment schemes and from other suppliers. Suppliers with significant market power should not recreate access restrictions or wholesale prices that would be prohibited if introduced by a scheme.

**5.50** This condition seems to be aimed at two tackling two separate issues:

- suppliers seeking to introduce bilateral agreements in order to avoid rules which are focussed on schemes; and
- the withholding of co-operation in the development of payment systems.

**5.51** The Government does not believe that a general rule is needed to ensure that suppliers with significant market power cannot recreate access restrictions or wholesale prices that would be prohibited if introduced by a scheme. It is difficult to see how such a rule could be put in place that would provide sufficient certainty to affected parties about its meaning. It is intended that the rules themselves will apply to participants in the provision of payment services and so whether or not particular behaviour was prohibited by those rules should not be dependent on the existence of a scheme rather than bilateral agreements.

**5.52** However, the Government sees merits in prohibiting the withholding of co-operation in the development of payment systems, or, put positively, imposing a duty to co-operate. There is an analogous model in the telecommunications arena under which in certain circumstances operators are placed under an obligation to supply existing services or even to introduce new services to satisfy reasonable demand. For example, Condition 53 of BT's licence deals with special network access:

**53.2** The Licensee shall deal with reasonable requests for special network access except where the Director has determined... that this obligation does not apply on a case by case basis and on the grounds that there are technically and commercially viable alternatives to the special network access requested and that the requested access is inappropriate in relation to the resources available to meet the request...

**53.3** The Licensee shall grant the organisation making the request an opportunity to put its case to the Director before a final decision is taken to restrict or deny access in response to a particular request.

**53.4** Where the Licensee denies a request for special network access, the Licensee shall give the organisation making the request a prompt and fully reasoned explanation of why the request has been refused.

**53.5** Subject to intervention by the Director... technical and commercial arrangements for special network access shall be a matter for agreement between the parties involved...

**5.53** This obligation to supply does not apply where the "demand or the prospective demand for the service is not sufficient, having regard to the revenue likely to be earned from the provision of the service... to meet all the costs reasonably to be incurred by the Licensee [BT] in providing the service". Also, it does also not apply when the regulator agrees that "it is not reasonably practical in all the circumstances" for BT to provide the service requested at the time or place demanded.

**5.54** In imposing a duty to co-operate the Government believes it is important to ensure that the rule addresses these cost issues and includes concepts of proportionality and reasonableness. So for example, a duty to co-operate might not apply where there were technically and commercially viable alternatives or in other defined circumstances.

**5.55** Another issue, in imposing a duty to co-operate, is the scope of that co-operation. In other words, to what activities would it apply – would it be co-operation in:

- the development of existing services or enhanced services or new services?

- the development of competing systems? or
- facilitating the provision of payment services to end users?

The Government would welcome views on these issues and on the circumstances in which co-operation could be reasonably required.

*Q28. Should the rule dealing with co-operation be aimed at requiring participants to cooperate in the development of payment services where:*

- (a) a failure to co-operate would have a material effect on competition; and*
- (b) it is reasonable to require such co-operation.*

*If so, in what circumstances would it be reasonable to require cooperation?*

## **Other rules**

**5.56** The Government believes that the above set of rules would be sufficiently comprehensive to tackle the competition problems highlighted in the Cruickshank report. Nonetheless, it would welcome views on whether any other rules are necessary.

*Q29. Are any other rules necessary to tackle the competition problems associated with payment systems?*