Competition Act 1998

Decision of the Office of Fair Trading

No. CA98/05/05

Investigation of the multilateral interchange fees provided for in the UK domestic rules of Mastercard UK Members Forum Limited (formerly known as MasterCard/Europay UK Limited)

6 September 2005
(Case CP/0090/00/S)
# TABLE OF CONTENTS

## SUMMARY

OVERVIEW

## I  FACTS AND PROCEDURE

### A  FACTS

- Background to Payment Card Systems in the United Kingdom
- The Parties
- The UK Domestic Rules
- MMF’s Interchange Fee Arrangements, 1 March 2000 – 18 November 2004
- The Market Position of Mastercard

### B  PROCEDURE

## II  LEGAL AND ECONOMIC ASSESSMENT

### A  The Requirements of Articles 3 and 16 of the Modernisation Regulation, Section 60 of the CA98 and the OFT’s Obligations Under Community Law

#### Community Law

- Summary
- Background
  - The Commission’s Visa International proceedings
  - Points of similarity with the Visa MIF Decision
- The OFT’s View
  - Community law
  - Section 60 of the CA98
- Further Observations on the Arguments Raised by the Parties, Visa and Amex
  - MMF
  - Visa and Amex

### B  The Relevant Markets

#### Summary

- Wholesale and Acquiring
- Issuing
- Other factors
- Conclusion

### Introduction to Market Definition

- The OFT’s position on the focal products
- The view of the Parties on the focal products
- The OFT’s findings on the Parties’ views
- Framework for analysis of substitution
- The hypothetical monopolist test: the wholesale market
- The hypothetical monopolist test: the acquiring market
- The pass through of a MIF increase to MSCs
- The MMF MIF and cardholder incentives
- Alternative payment methods
Exiting: would merchants exit following a 5-10 per cent increase in an MSC? 77
Surcharging: would merchants surcharge following a 5-10 per cent increase in an MSC? 87
Additional evidence supplied by the Parties: MMF’s SSNIP test analysis 98
The OFT’s conclusions on the wholesale and acquiring markets 100
The issuing market 101
Supply-side substitution 108
The Commission’s treatment of product market definition in the Visa MIF decision 109

THE RELEVANT GEOGRAPHIC MARKET 111
THE OFT’S CONCLUSION ON MARKET DEFINITION 111

C  ARTICLE 81 AND THE CHAPTER I PROHIBITION 113
STANDARD AND BURDEN OF PROOF 113
AGREEMENTS BETWEEN UNDERTAKINGS, DECISIONS BY ASSOCIATIONS OF UNDERTAKINGS AND CONCERTED PRACTICES 114
  Effect on trade within the UK 114
  Effect on trade between Member States 115
OBSERVATIONS ON THE ECONOMICS OF FOUR-PARTY PAYMENT CARD SCHEMES 119
SUMMARY OF THE OFT’S FINDINGS ON THE APPLICATION OF ARTICLE 81(1) AND THE CHAPTER I PROHIBITION 121

D  THE COLLECTIVE PRICE RESTRICTION 123
OBJECT OF THE COLLECTIVE PRICE RESTRICTION 123
EFFECT OF THE COLLECTIVE PRICE RESTRICTION 124
  Restriction in the wholesale market 124
  Restriction in the acquiring market 129
  Restriction in the issuing market 129
REPRESENTATIONS AND SUBMISSIONS ON COLLECTIVE PRICE RESTRICTION IN THE WHOLESALE MARKET 130
  Restrictions have not been considered in the correct legal framework 130
  The MMF MIF has not been considered in its economic context 134
  The MMF MIF agreement is not a collective pricing agreement 135
  The MMF MIF agreement is essential to the MasterCard scheme 136
  The MMF MIF agreement falls within the Commission’s Horizontal Guidelines or is an ancillary restraint 139
  Arbitration is not a viable alternative fallback mechanism 147
  Competition would be the same with or without the MMF MIF 149
REPRESENTATIONS AND SUBMISSIONS ON COLLECTIVE PRICE RESTRICTION IN THE ACQUIRING MARKET 152
  Summary of arguments made 152
  The OFT’s response 153
APPRECIABLE RESTRICTION OF COMPETITION 153
CONCLUSION ON THE APPLICATION OF ARTICLE 81(1) AND THE CHAPTER I PROHIBITION TO THE COLLECTIVE PRICE RESTRICTION 156
THE APPLICATION OF ARTICLE 81(3) AND SECTION 9 OF THE CA98 TO THE COLLECTIVE PRICE RESTRICTION 156
  Summary of the OFT’s findings on the application of Article 81(3) and section 9 of the CA98 to the collective price restriction 157
  First exemption condition: Contributes to improving production or distribution, or promoting technical or economic progress 158
  Third exemption condition: Indispensability of the restrictions 161
  Second exemption condition: Allowing consumers a fair share of the resulting benefit 190
  Fourth exemption condition: No elimination of competition in respect of a substantial part of the products in question 195
E THE EXTRANEOUS COSTS RESTRICTION
THE OBJECT OF THE EXTRANEOUS COSTS RESTRICTION 196
EFFECT OF THE EXTRANEOUS COSTS RESTRICTION 197
REPRESENTATIONS AND SUBMISSIONS ON THE EXTRANEOUS COSTS RESTRICTION IN THE ACQUIRING AND ISSUING MARKETS 200
Extraneous costs may be recovered through bilateral interchange fees 200
MasterCard scheme must allocate costs on the same basis as its competitors 201
The extraneous costs restriction falls within the Horizontal Guidelines 202
The MasterCard scheme is a joint product with joint costs 202
Merchants should contribute to interest-free and cardholder default guarantee costs 203
Allocation of costs cannot give rise to a restriction 207
APPRECIABLE RESTRICTION OF COMPETITION 208
CONCLUSION ON THE APPLICATION OF ARTICLE 81(1) AND THE CHAPTER I PROHIBITION TO THE EXTRANEOUS COSTS RESTRICTION 208
THE APPLICATION OF ARTICLE 81(3) AND SECTION 9 OF THE CA98 TO THE EXTRANEOUS COSTS RESTRICTION 208
Merchants benefit from the recovery of extraneous costs through the MMF MIF 209
CONCLUSION ON THE APPLICATION OF ARTICLE 81(3) AND SECTION 9 OF THE CA98 TO THE EXTRANEOUS COSTS RESTRICTION 211

III DECISION
A PENALTIES 212
B DIRECTIONS 212
ANNEX 1: THE PARTIES TO THE UK DOMESTIC RULES 213
ANNEX 2: HYPOTHETICAL MONOPOLIST TEST IN THE ISSUING MARKET 217
ANNEX 3: OXERA STUDY ON BENEFITS TO MERCHANTS FROM THE EXTENSION OF CREDIT 222
ANNEX 4: EFFECT OF THE MMF MIF ON RETAIL PRICES 229
ANNEX 5: UNIVERSITY OF WESTMINSTER STUDY 235
ANNEX 6: FACTS INTERNATIONAL MERCHANT SURVEY 236
ANNEX 7: LOYALTY SCHEMES AND AFFINITY ARRANGEMENTS 238
ANNEX 8: THE MMF MERCHANT STUDY 240
ANNEX 9: OTHER EC CASE LAW RELIED ON BY THE PARTIES 251
ANNEX 10: DOTECON DISCOURAGEMENT SURVEY 254
SUMMARY

The Office of Fair Trading has concluded that members of the MasterCard UK Members Forum and other MasterCard licensees in the UK have been party to an agreement which infringes both:

- the prohibition in Article 81(1) of the EC Treaty; and
- the 'Chapter I prohibition' in section 2 of the Competition Act 1998.

This agreement, setting the level of the fallback multilateral interchange fee which applied to all transactions made using UK issued MasterCard cards, was effective from 1 March 2000 to 18 November 2004. From 18 November 2004, new arrangements for setting the fallback interchange fee applying to UK MasterCard transactions were introduced.

The OFT has found that the infringing agreement has restricted competition in two ways. First, it gave rise to a collective agreement on the level of the multilateral interchange fee (essentially, a collective agreement on price). Secondly, it resulted in the unjustified recovery of certain costs ('extraneous costs') incurred by MasterCard UK Members Forum members and other MasterCard licensees through the multilateral interchange fee.

The infringing agreement was notified to the OFT for decision on 1 March 2000. In light of all circumstances of this case, the OFT does not consider it appropriate to impose a penalty in respect of the infringement arising from the agreement. Because the agreement is now at an end, the question of directions does not arise in this case. However, the principles which inform this Decision are likely to be applicable to the new arrangements for setting the fallback interchange fee.

Confidential information is redacted from the published version of this Decision which is available on the OFT’s Competition Act 1998 Public Register (http://www.oft.gov.uk/Business/Competition+Act/default.htm). Where confidential information is redacted from this version, this is either denoted by [REDACTED] or is substituted with [Indicative information only].
OVERVIEW

i. This Overview is provided by the OFT to assist the readers of this Decision. It outlines the main conclusions made in this Decision. It does not set out all of the facts on which the OFT bases this Decision or its reasons for making this Decision. These facts and reasons are contained in main body of the document.

BACKGROUND TO THE UK DOMESTIC RULES AND THE MMF MIF AGREEMENT (PARAGRAPHS 1-72)

ii. This Decision concerns arrangements contained in the UK Domestic Rules of the MasterCard UK Members Forum Limited ('MMF') for setting the fallback multilateral interchange fee ('the MMF MIF') which applied to domestic UK MasterCard transactions between 1 March 2000 and 18 November 2004 ('the MMF MIF agreement'). Although the MMF MIF agreement is now at an end, for the purposes of analysis in this Decision it is discussed in the present tense.

iii. The parties to the MMF MIF agreement are:

- MMF (as a body corporate);
- the members of MMF;
- MasterCard International Incorporated ('MCI');
- MasterCard Europe sprl ('MCE'); and
- the principal and affiliate UK licensees of MCE/MCI,

and are collectively referred to in this Decision as the 'Parties' unless otherwise specified.

iv. In making this Decision, the OFT has carefully considered information from a wide range of sources provided during its administrative procedure preceding this Decision. In particular, it has considered:

- written and oral representations made by the Parties; and
- written submissions made by other persons.

ARTICLE 3 AND SECTION 60 (PARAGRAPHS 73-136)

v. The OFT takes the view that that neither Community law, nor section 60 of the Competition Act 1998 ('CA98') requires it, in light of the European Commission’s decision on the Visa intra-regional MIF, to decide that the MMF MIF agreement is exempt from Article 81 and the Chapter I prohibition. In addition, the OFT considers that, where in this Decision it has taken a different approach from that taken by the European
Commission in the *Visa MIF* decision to specific issues, it has fully justified doing so.

THE RELEVANT MARKETS (PARAGRAPHS 137-345)

vi. The OFT has taken as its starting point for the definition of the relevant market the supply of three distinct types of services related to the MMF MIF agreement:

- the supply of services provided between issuers and acquirers for the completion of purchases made using MasterCard branded consumer credit and charge cards ('Wholesale');
- the supply of services provided by acquirers of MasterCard branded consumer credit and charge cards to merchants ('Acquiring'); and
- the supply of services provided by issuers of MasterCard branded consumer credit and charge cards to cardholders ('Issuing').

vii. Using the hypothetical monopolist test framework to examine the relevant constraints on the pricing of these services, and therefore the bounds of each of the relevant markets, the OFT has defined the following relevant markets in this Decision:

- the market for the provision of card transaction services between issuers and acquirers for purchases made by way of MasterCard branded consumer credit and charge cards in the UK;
- the market for the provision of merchant acquiring services by acquirers to merchants for purchases made by way of MasterCard branded consumer credit and charge cards in the UK; and
- the market for the provision of branded credit and charge card issuing services by issuers to cardholders in the UK.

RESTRICTIONS

viii. The OFT finds that the MMF MIF agreement gives rise to two restrictions of competition: the 'collective price restriction' and the 'extraneous costs restriction'.

ix. These are independent restrictions and have been assessed by the OFT separately. The OFT considers that the MMF MIF agreement is caught by the prohibitions against anticompetitive agreements in Article 81(1) of the EC Treaty and the Chapter I prohibition of the CA98 on the basis of *each* restriction of competition.
Collective price restriction (Paragraphs 388-674)

x. The collective price restriction arises because the MMF MIF agreement involves collective agreement on the amount of the MMF MIF which applied to almost all domestic transactions until 18 November 2004.

xi. The MMF MIF reduces incentives for the Parties to seek benefit from efficiencies and determine pricing policy individually by entering bilateral agreements in which the amount of the applicable interchange fee differs from the MMF MIF.

xii. In addition, the MMF MIF operates as a significant and common price floor for Merchant Service Charges ('MSCs') charged by acquirers to merchants, and has a direct effect on MSCs paid by merchants to acquirers. Therefore, the existence of the MMF MIF restricts the scope for intra-scheme competition between acquirers on the amount of MSCs paid by merchants.

xiii. The OFT considers that there are benefits flowing from the existence of the MMF MIF which satisfy the first exemption condition and which would not be available if issuers and acquirers were required to enter into bilateral agreements setting interchange fees (see paragraphs 520-532). However, the recovery of extraneous costs (i.e. costs of services which are not necessary for the operation of the MasterCard scheme as a payment transmission mechanism – see paragraph 526) through the MMF MIF means that the collective price restriction is not indispensable to the attainment of the benefits created by the MMF MIF agreement (see paragraphs 533-587). Accordingly, the MMF MIF agreement does not meet the criteria for exemption in Article 81(3) or section 9 of the CA98.

Extraneous costs restriction (Paragraphs 675-742)

xiv. The extraneous costs restriction arises because extraneous costs are recovered through the MMF MIF, which as a result exceeds payment transmission costs incurred by issuers.

xv. The recovery of extraneous costs through the MMF MIF results in acquirers paying an unduly high interchange fee. This higher interchange fee is reflected in higher MSCs through which the cost of the MMF MIF is passed on and recovered from merchants directly, and from consumers indirectly where merchants increase retail prices to recover the costs of MSCs.

xvi. As an increase in costs faced by all acquirers, a higher MMF MIF influences both the ability and willingness of acquirers to compete on the amount of MSCs charged to merchants.

xvii. Competition between issuers is distorted by the passing on of extraneous costs because, when these costs are recovered via the MMF MIF, they provide a large flow of revenue to issuers, and incentives for issuers to induce consumers to hold and use cards (e.g. through loyalty schemes,
advertising and funding the provision of an interest-free period). The resulting cardholder inducements make the MasterCard scheme more attractive as a payment method (for cardholders and prospective cardholders) relative to alternatives such as debit cards, cheques or cash.

xviii. As well as distorting competition between payment schemes, the recovery of extraneous costs through the MMF MIF also distorts competition between issuers within the MasterCard scheme.

xix. It has not been demonstrated that there are benefits from the recovery of extraneous costs through the MMF MIF that represent appreciable objective advantages of such a character as to outweigh the disadvantages to competition. Accordingly, the MMF MIF agreement does not meet the criteria for exemption in Article 81(3) or section 9 of the CA98.

DECISION (PARAGRAPHS 743-747)

xx. The OFT finds that the MMF MIF agreement, which applied from 1 March 2000 to 18 November 2004, restricted competition within the meaning of Article 81(1) and the Chapter I prohibition and did not meet the exemption conditions set out in Article 81(3) and section 9 of the CA98.

xxi. The OFT does not consider it appropriate to impose a penalty in this case, and the question of directions does not arise.
I FACTS AND PROCEDURE

A FACTS

BACKGROUND TO PAYMENT CARD SYSTEMS IN THE UNITED KINGDOM

1. Customers in the United Kingdom (‘UK’) use three main methods for making spontaneous payments: cash, cheques and payment cards. The four main types of payment cards are: credit cards, charge cards, store cards and debit cards.

2. Credit card holders can use their card to buy goods and services and to withdraw cash up to a pre-arranged limit. They receive a statement, usually on a monthly basis, and can settle the balance in full or in part. Charge cards work in the same way as credit cards except that the balance must be paid in full by the payment date. Store cards are similar to credit cards in that customers do not need to pay the balance in full by the payment date, though their use is normally restricted to the issuing group of retailers. Debit cards are by definition linked to a particular bank or building society account, and goods or services are paid for, or cash withdrawn, by automatically debiting the cardholder’s account.

3. MasterCard and Visa are the principal credit and charge card schemes in the UK. American Express (‘Amex’) and Diners Club International (‘Diners’) have a significant share of UK charge card transactions (although the number of charge cards in issue and the volume and value of charge card transactions is small relative to the number of credit cards in issue and the volume and value of credit card transactions). Amex also issues a small number of credit cards. Visa, S2 Card Services Limited (‘S2’) and MasterCard operate debit card schemes in the UK.

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1 The other main methods of consumer payments are direct debits and standing orders.
3 See Tables 3-5 below.
4 Page 141 and Figure 37, Datamonitor, UK Plastic Cards 2005 DMFS1744 (June 2005).
5 See Tables 1, 4A, 4B, APACS Plastic Card Review 2005 (May 2005). In 2004, 94 per cent of credit and charge cards in issue in the UK were MasterCard and Visa credit cards; and MasterCard and Visa credit cards accounted for 81 per cent of the transaction value of purchases in the UK made using UK-issued credit and charge cards. A large proportion of charge cards are business cards (also referred to as commercial or corporate cards).
6 Datamonitor, UK Plastic Cards 2005 DMFS1744 (June 2005), page 140, estimates that in 2004 0.16 per cent of the total value of transactions made with UK-issued credit cards was made with Amex credit cards.
7 Visa debit and Electron cards are part of the Visa scheme. S2 has operated the schemes for Switch and Solo branded debit cards. Since 2002, members of the Switch scheme have been in the process of migrating to MasterCard’s Maestro brand in place of the Switch brand and of moving to a new transaction processing system operated by MasterCard. In effect Switch has become a UK domestic Maestro debit card scheme run by S2, although this process has not yet been fully completed.
4. Amex and Diners are in essence proprietary three-party payment card systems. The three parties are Amex/Diners, their cardholders and the merchants who accept Amex/Diners cards. For example, Amex provides the network for the scheme to operate, recruits cardholders and issues cards, and also recruits merchants to the scheme and acquires their transactions made on Amex cards. Amex obtains revenue from cardholders in the form of annual fees, late payment charges and other sundry charges and from merchants in the form of merchant fees which are calculated as a percentage of the value of each card transaction.

5. MasterCard and Visa are member associations made up of banks that are licensed to issue and/or acquire their respective branded cards, and they have a significant number of members in common. For purchases made using credit, charge and debit cards, both MasterCard and Visa operate four-party payment card systems. The four parties are:

- the cardholder purchasing the goods or services;
- the bank that issued the card (the 'issuer');
- the merchant who provides the goods or services to the cardholder; and
- the bank that deals with the merchant (the 'acquirer').

6. MasterCard and Visa provide the networks through which purchases made using their respective branded cards are processed but it is their member banks that deal directly with and provide services to cardholders and merchants as issuers or acquirers. Issuers are responsible inter alia for recruiting cardholders and for making payment to acquirers for goods or services purchased by the cardholder. Acquirers are responsible inter alia for recruiting merchants, for forwarding transaction details to issuers and for making payment to the merchant. Merchants pay acquirers a fee, or merchant service charge ('MSC'), on each transaction. MSCs are usually a proportion of the retail price for credit and charge card transactions and a fixed fee for debit card transactions.

7. Within a four-party payment card system, an interchange fee is an inter-bank payment made between the issuer and the acquirer, and typically is paid by the acquirer to the issuer. Where the interchange fee is set at the scheme level rather than by bilateral negotiation or arbitration, it is

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8 In April 2005, Amex and Lloyds TSB announced that Lloyds TSB will issue Amex branded credit cards in the UK. Previously Capital One issued Amex branded cards in the UK but this arrangement has now ended.
9 Purchases can be made either at a point-of-sale ('POS') terminal or remotely, for example by mail order, telephone or the internet.
10 It may be that for a particular transaction in a four-party system the issuer is also the acquirer. This is known as an 'on-us' transaction.
11 Some acquirers contract out their transaction processing activities either to another acquirer or to a third party specialist transaction processor. However, the acquirer remains responsible for the actions of the transaction processor.
referred to as a fallback interchange fee or a multilateral interchange fee ('MIF'). For credit and charge card transactions the MIF is calculated as a proportion of the retail price, while for debit card transactions a fixed pence per transaction fee has typically been charged.\footnote{Interchange fees for credit and charge card transactions can be shown to be much higher on average than those for debit card transactions. See Don Cruickshank \textit{Competition in UK Banking – A Report to the Chancellor of the Exchequer} ISBN 0 11 560075 2 (March 2000) (the 'Cruickshank Report'), D3.46-47 and Chart D3.4.}

8. A typical four-party payment card transaction involves the following steps (see Figure 1 below):

(i) the cardholder agrees to pay the merchant for the relevant good or service, the card details are checked and the transaction authorised;

(ii) the merchant sends the transaction details to the acquirer;

(iii) the acquirer in turn forwards the transaction details to the issuer;

(iv) the issuer pays the acquirer the retail price less an interchange fee;

(v) the acquirer pays the merchant the retail price less an MSC; and

(vi) the issuer debits the retail price to the cardholder’s account.

\textbf{Figure 1: A typical four-party payment card transaction}

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\footnote{Interchange fees for credit and charge card transactions can be shown to be much higher on average than those for debit card transactions. See Don Cruickshank \textit{Competition in UK Banking – A Report to the Chancellor of the Exchequer} ISBN 0 11 560075 2 (March 2000) (the 'Cruickshank Report'), D3.46-47 and Chart D3.4.}
9. An MSC inevitably includes the interchange fee paid by the acquirer to the issuer and also typically includes other sundry charges for costs incurred by the acquirer for a payment card transaction. For example, if Mr Smith uses a credit card issued by Bank C to purchase a TV set for £1,000, the merchant’s acquirer, Bank A, receives information from the merchant (step (ii)) and passes it to Bank C (step (iii)). Bank C then pays Bank A the retail price less an interchange fee (step (iv)). Bank A then pays the merchant the retail price less an MSC (step (v)). For the purposes of illustration, if the interchange fee was one per cent and the applicable MSC was two per cent of the retail price, Bank C would receive an interchange fee of £10, Bank A would receive £10 (the applicable MSC less the interchange fee) and the merchant would receive £980 (the retail price less the applicable MSC).

10. In the UK merchants have not been prohibited from recovering from consumers the cost of MSCs for credit card purchases since the Credit Cards (Price Discrimination) Order 1990 took effect on 7 March 1991. The Order made illegal rules in the MasterCard and Visa schemes, known as the ‘no-surcharge’, or ‘no-discrimination’ rules, which prohibited merchants from surcharging for card payments, or from allowing a discount for cash payments. In practice, however, surcharging is not widespread in the UK and tends to be limited to certain sectors.

11. Under MasterCard’s ‘honour all cards rule’ a merchant who agrees to accept MasterCard branded credit and charge cards must accept all of the scheme’s cards of that type regardless of which of the member banks issued the card. Hence a merchant who accepts a MasterCard branded credit or charge card issued by Bank A must also accept a MasterCard branded credit or charge card issued by Bank B or any other member bank of the MasterCard scheme.

12. Where debit cards are used to make a purchase, the retail price is usually debited from the cardholder’s bank account almost immediately. Credit

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13. The MSC is therefore typically higher than the interchange fee and for some (small) merchants significantly higher, see the Cruickshank Report, Chart D3.5. Data supplied in July and August 2004 by UK acquirers for the MasterCard scheme in response to an OFT information request made under section 26 of the Competition Act 1998 (the 'CA98') indicates that between 2001 and 2003, the MIF, on average, accounted for 80 per cent of the level of the MSC.


15. MasterCard abolished the no-discrimination rule in the European Economic Area as of 1 January 2005.

16. See paragraph 281 below.


18. For deferred/delayed debit cards there is a longer period of time before the amount of a purchase transaction is debited to a cardholder’s account. This type of debit card is comparatively uncommon in the UK.
and charge cards are not linked directly to a bank account, and a credit or charge card cardholder receives a statement of account listing any new transactions, typically on a monthly basis. The cardholder will then have a period of time to settle the account and there may be up to 59 days between the date of the purchase and the due date for payment depending on the terms and conditions in the agreement between the cardholder and the issuer. This is referred to as the 'interest-free period'.

13. Charge card cardholders are required to pay off the amount owed in full by the end of the interest-free period. Credit card cardholders have the option of paying off the amount due in full or in part (subject to a minimum payment) by the due date for payment. Credit card cardholders who settle their account in full by the due date are known as 'transactors' and benefit from the interest-free period. Those cardholders who make use of the extended credit facility offered by credit cards and roll over part of the balance of their account are known as 'revolvers'. They are charged interest on their purchases, usually from the date of each purchase, and in effect do not benefit from an interest-free period.

14. Some credit cards are associated with loyalty schemes and affinity arrangements. Loyalty schemes are typically offered by issuers and merchants to promote card usage and customer loyalty to the merchant(s) involved in the scheme. Some loyalty schemes are branded in the issuer’s own name and some only in conjunction with affinity cards. The loyalty schemes offer cardholders various benefits for using their cards (either generally or at a particular merchant) such as cash-back rewards, lower interest rates, redeemable points and air miles.

15. Affinity cards are credit cards issued in partnership with organisations, such as charities, clubs and other interest groups and offer cardholders the opportunity to support a certain organisation. The issuer transfers a royalty or donation to the affinity partner for each card issued and for each transaction. Affinity cards may be combined with loyalty schemes and, in general, the affinity partner bears the costs of any affinity card benefits to customers.

16. Most credit cards, charge cards and debit cards can be used not only to make purchases but also to obtain cash either from an Automated Teller Machine (‘ATM’) or from a bank counter. The great majority of cash withdrawals are made using debit cards at ATMs and for some of these

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19 Although some cardholders will establish an indirect link to a bank account by opting to pay all or part of the balance of a credit card by direct debit.
21 According to a survey commissioned by the OFT, 47 per cent of credit card cardholders may be classified as pure transactors, i.e. they pay off their account in full every month, while a further 13 per cent of credit card cardholders are transactors most of the time but sometimes roll over their balance: Chart 4.6, OFT709 *Credit Card Survey* (March 2004).
22 There are also ATM cards which are used specifically for cash withdrawals. When a debit card is used to make a purchase, it may be possible for the cardholder to obtain cash from the merchant.
transactions the ATM is deployed by the card issuer. Where the ATM is not deployed by the card issuer, the transaction is routed through the LINK ATM network and an interchange fee is often payable by the card issuer to the ATM provider.

17. Cash withdrawals made using credit and charge cards are generally routed through the MasterCard or Visa network, and for the MasterCard scheme an interchange fee, referred to as a 'service fee' is payable by the card issuing bank to the bank which provides the ATM or counter service.

18. A major recent technological development for credit, charge and debit cards has been the introduction of chip and PIN. In future, it is proposed that all credit and debit cards will contain a microchip (or 'chip') which will contain the card and account details. In addition, for POS transactions, the cardholder will be required to input a personal identification number ('PIN') into a keypad instead of signing a paper receipt as a means of identification.

THE PARTIES

19. MasterCard UK Members Forum Limited ('MMF') is an association of UK licensees of MasterCard Europe sprl ('MCE') and MasterCard International Incorporated ('MCI'). MMF has as its members and shareholders the main (but not all) UK banks which issue MasterCard payment instruments and which are licensed to use the trade and service marks of MasterCard in the UK. MMF is governed by a Board of Directors taken from its larger members and representatives of MCI and MCE.

20. MMF was established in 1989 as MasterCard & Eurocard Members (UK & Republic of Ireland) Forum Limited, a limited liability company, to address issues relating to the Eurocard/MasterCard payment scheme within the UK and Republic of Ireland. Following the merger in 1992 of Eurocard International S. A. with eurocheque International S. C. and eurocheque International Holdings S. A. to form Europay International S. A., the name was changed to MasterCard Europay UK Limited ('MEPUK'). At the same time, MEPUK took over responsibility for the eurocheque scheme in the UK and relinquished responsibility for Eurocard/MasterCard licensees in the Republic of Ireland.

21. On 12 June 2002, the business of MEPUK was transferred to MasterCard Europay UK (2002) Limited ('MEPUK 2002'). MEPUK 2002 subsequently changed its name to MMF. References in this Decision to MMF include, where appropriate, references to MEPUK and MEPUK 2002.

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23 See footnote 9 above.

24 Formerly known as Europay International S. A. ('EPI'). The corporate name of EPI was changed to MCE on 16 July 2002 to reflect the integration of EPI into the MasterCard group of companies, with MCE being a subsidiary of MCI. References in this Decision to MCE include, where appropriate, references to EPI.

25 Letter from Denton Wilde Sapte to the OFT (19 June 2002).

26 Certificate of incorporation on change of name dated 17 December 2002.
22. The purpose of MMF is to enable its members as issuers of MasterCard payment instruments, and/or acquirers of transactions undertaken using such instruments, to liaise over issues relating to the development of the MasterCard payment scheme in the UK, and world-wide, as it affects its members, and to present their position regarding such issues to MCI and MCE. MMF does not issue or accept any payment instruments itself nor does it have any direct relationship with merchants or cardholders.

23. From 1 March 2000, MMF was responsible for the adoption of the UK Domestic Rules for the Eurocard/MasterCard product (the 'UK Domestic Rules'), the rules specific to the UK relating to the MasterCard product. Prior to this date, these rules were adopted by MCE.

24. UK licensees of MCE/MCI are not obliged to join MMF in order to be able to issue MasterCard payment instruments or acquire transactions undertaken with such payment instruments in the UK but the UK Domestic Rules are mandatory and enforceable against all UK licensees of the MasterCard trademark, whether or not they are members of MMF.

25. The members of MMF and other UK principal and affiliate licensees of MCE/MCI are listed in Annex 1 (Parties to the UK Domestic Rules) of this Decision, where changes which have occurred since 1 March 2000 are indicated. Principal licensees are jointly and severally liable for the affiliate licensees they sponsor.


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27 See Annex 1 of this Decision.
28 Letter from Jones Day to the OFT (28 June 2005). National Westminster Bank plc and Ulster Bank Limited are part of the Royal Bank of Scotland Group (‘RBSG’).
29 A&L sold the merchant acquiring business of its wholly owned subsidiary, Alliance & Leicester Commercial Bank plc (formerly Girobank), to EuroConex Technologies UK Limited (‘ECX’) on 30 April 2004 and ownership of the business is vested in ECX. The acquiring business continues to be marketed under the A&L brand and A&L acts as the MasterCard sponsor for the A&L branded merchant services business in the UK: response by A&L to a request for information, dated 9 July 2004, made under section 26 of the CA98 (4 August 2004).
30 Bank of Ireland acts as the MasterCard sponsor for ECX which conducts Bank of Ireland’s merchant acquiring business in the UK.
31 Europe Card Acceptance (‘ECA’) is the merchant acquiring business of Citigroup in Europe. Part of its business operates from the UK under a cross-border acquiring programme and also under a global airline acquiring programme. As part of these programmes, ECA acquires transactions made on UK-issued MasterCard credit and charge cards (and UK-issued Visa credit, charge and debit cards) where these cards are used in the UK-based outlets of its international merchants. This UK-based acquiring represents approximately one per cent of ECA’s acquiring business. Information provided in an e-mail from Citigroup to the OFT (1 July 2005).
32 [REDACTED].
Royal Bank of Scotland plc ('RBS') and Ulster Bank Limited. All the acquirers are also issuers except A&L.

27. MMF did not originally identify MCE or MCI as parties to the UK Domestic Rules. On 23 October 2001, MCE and MCI wrote to the OFT arguing that in view of, inter alia, their position as licensors of and participants in the administration of the MasterCard product, they did in fact constitute parties to the UK Domestic Rules for the purposes of the CA98.

28. On 29 November 2001, the MMF Board of Directors adopted an amendment to the UK Domestic Rules obliging the MMF Board to consult with and give due regard to the views of MCE and MCI in the setting of fallback interchange fees. On 5 December 2001, this resolution was notified to the OFT as a material change to the UK Domestic Rules, pursuant to rule 4(a) of the Director’s rules. The OFT then afforded MCE and MCI procedural rights as parties to the UK Domestic Rules.

29. MMF, MCI, MCE, members of MMF and other principal and affiliate UK licensees of MCE/MCI, listed at Annex 1 of this Decision, are collectively referred to in this Decision as the ‘Parties’ unless otherwise specified.

THE UK DOMESTIC RULES

30. Prior to 1 March 2000, the UK Domestic Rules were developed and maintained by MCE in consultation with MMF. In February 1999, MCE adopted a rule which provided that rules applicable to all domestic transactions in a country may be agreed by a group of members representing at least 75 per cent of both the Eurocard/MasterCard issuing and acquiring domestic POS volumes in that country. As the members of MMF satisfied this condition, the MMF Board elected at its December 1999 meeting to adopt the UK Domestic Rules with effect from 1 March 2000.

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33 In addition, there are a number of non-UK based licensees who are entitled to acquire UK domestic transactions from certain international merchants.
34 A&L sold its consumer credit card business to MBNA Europe plc on 1 August 2002 and has not issued any MasterCard credit cards since January 2003. By agreement between MBNA and A&L, the consumer credit card business continues to be marketed under the A&L brand but the cards are issued by MBNA. Response by A&L to a request for information, dated 9 July 2004, made under section 26 of the CA98 (4 August 2004).
35 Letter from Jones, Day, Reavis & Pogue (now Jones Day) to the OFT (23 October 2001).
36 Letter from Denton Wilde Sapte to the OFT (5 December 2001).
37 The Competition Act 1998 (Director’s rules) Order 2000, SI 2000 No 293 (the ‘Director’s rules’). As from 1 April 2003, the Enterprise Act 2002 transferred the functions of the Director General of Fair Trading to the OFT. With effect from 17 November 2004, the Director’s rules were replaced by The Competition Act 1998 (Office of Fair Trading’s Rules) Order 2004, SI 2004 No 2751 (the ‘OFT’s rules’).
31. The UK Domestic Rules were revised in October 2002. References in this Decision to the UK Domestic Rules are to the revised rules dated October 2002.

32. The UK Domestic Rules apply to transactions made with UK-issued cards provided by issuing banks in the UK that carry the MasterCard trademark, i.e. MasterCard credit and charge cards. The UK Domestic Rules do not apply to other products offered by MasterCard such as Maestro debit cards and Cirrus ATM cards.

33. UK domestic transactions made using MasterCard branded cards are subject to MCE and MCI rules, except where there is a specific domestic rule that varies the international rule (clause 1.0, UK Domestic Rules).

34. The UK Domestic Rules set out the operating regulations specific to UK domestic transactions for the MasterCard scheme. In clause 1.0 of the UK Domestic Rules, domestic MasterCard transactions are defined as “transactions that take place in the UK between a merchant and a cardholder with a UK-issued card”; and for the purposes of the rules, the UK is defined as “consisting of Great Britain, Northern Ireland, the Channel Islands and the Isle of Man”.

35. The UK Domestic Rules are mandatory and enforceable against all UK licensees of the MasterCard trademark (regardless of whether they are members of MMF) and contain provisions that establish the terms and conditions on which services are provided between acquiring and issuing banks for domestic transactions in the UK. Up to 18 November 2004, the UK Domestic Rules included provisions regarding domestic UK interchange fees, including fallback interchange fees, which were set out in Chapter 4 of the revised UK Domestic rules on 'Interchange Processes and Fees'.

36. At its meeting on 18 November 2004, the MasterCard Global Board of Directors decided [REDACTED]. This had the effect of rescinding MMF’s delegated authority under the UK Domestic Rules to set the level of fallback interchange fees and fallback service fees for MasterCard branded consumer and commercial cards in the UK. From 18 November 2004, [REDACTED].

37. This Decision by the OFT concerns MMF’s arrangements regarding fallback interchange fees applicable to domestic UK transactions between 1 March 2000 and 18 November 2004, in accordance with the UK

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38 Letter from Denton Wilde Sapte to the OFT (17 January 2003) with attached copy of the revised rules.
39 A MasterCard card is issued in the UK if the BIN (bank identification number) on the card has been allocated to the issuer in respect of its licence to use the MasterCard trademark in the UK (Clause 1.0, UK Domestic Rules).
40 Clause 1.0, UK Domestic Rules.
41 The provisions on interchange fees were previously set out in Chapter 13 of the UK Domestic rules on 'Interchange and Service Fee Programmes'.
42 [REDACTED].
Domestic Rules. In this Decision, these arrangements are referred to as the 'MMF MIF agreement' and the fallback interchange fees are referred to as 'the MMF MIF'. This Decision only concerns MasterCard branded consumer credit and charge cards – it does not concern and makes no findings in respect of MasterCard branded business cards.43

MMF’S INTERCHANGE FEE ARRANGEMENTS, 1 MARCH 2000 – 18 NOVEMBER 2004

38. MCE has laid down a set of basic rules for the setting of domestic interchange fees in the European region: bilaterally agreed interchange fees always prevail over fallback interchange fees; in the absence of a bilaterally agreed interchange fee, the fallback interchange fee for the country must be applied to MasterCard transactions; and, in the absence of either a bilaterally agreed interchange fee or a fallback interchange fee, the intra-European fee must be applied to domestic MasterCard transactions.44

39. In addition, MCE has laid down principles known as the Golden Rules to be followed by organisations setting domestic fallback interchange fees in the European region: the fees must bear a close relationship with costs, whilst at the same time, allow banks to take commercial considerations into account; they must be non-discriminatory and justifiable; and, interbank arrangements must never result in the fixing of cardholder fees or MSCs. 45

40. According to clause 4.6 of the UK Domestic Rules: "The scheme encourages members to make reasonable endeavours to agree commercially driven bilateral interchange fees, but in the absence of a Bilateral Interchange Agreement, Domestic Fallback Interchange Fees will apply."

41. Clause 4.6.1 treats Interchange and Arbitration:

"Where two UK members have been unable to agree on the bilateral interchange fee to be used, either member may refer the dispute to MasterCard Europe for an arbitration decision. During the arbitration process, in the absence of an existing Bilateral Interchange Agreement, Domestic Fallback Interchange Fees will apply. Once the arbitration decision has been made, the arbitrated figure will apply with effect from the date that MasterCard Europe received the arbitration request."

43 During the period covered by the Decision, MasterCard’s European intra-regional fallback interchange fee rate for business card transactions applied to purchases in the UK made by means of UK-issued MasterCard business cards: letter from Denton Wilde Sapte to the OFT (12 July 2002); clause 4.7.2, UK Domestic Rules.
44 Eurocard Rule Book (version 1.9, July 1999), clause 6.2.4, Order of Precedence.
45 Eurocard Rule Book (version 1.9, July 1999), clause 6.2.4, Golden Rules.
42. MCE provided information to the OFT about the bilateral arrangements in place between those UK banks which chose to clear their MasterCard credit and charge card purchase transactions through the European Common Clearing and Settlement System ('ECCSS').\textsuperscript{46} This information (set out in Table 1 below), indicates that between 1997 and 1999 a very small number of banks, responsible for less than one per cent of transactions, had bilateral arrangements, as opposed to relying on fallback fees. The figures also show that the percentage declined between 1997 and 1999.

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>&lt;0.05%</td>
<td>&lt;0.005%</td>
<td>&lt;0.002%</td>
</tr>
<tr>
<td>No of transactions</td>
<td>&lt;0.05%</td>
<td>&lt;0.005%</td>
<td>&lt;0.002%</td>
</tr>
</tbody>
</table>

43. Information provided by UK acquirers for the MasterCard scheme in July and August 2004, in response to an information request from the OFT, indicated that between 2001 and 2003 there were no bilateral arrangements in place between MasterCard issuers and acquirers in the UK.\textsuperscript{47}

44. During the period covered by this Decision, the UK Domestic Rules contained provisions on fallback interchange fees ('MIFs') payable by merchant acquirers to card issuers for UK domestic transactions made by means of UK-issued MasterCard credit and charge cards in the absence of bilateral agreements or arbitration.

45. The categories of UK domestic fallback interchange fees for MasterCard credit and charge card transactions were determined by the MMF Board of Directors. For each category, the level of the fallback interchange fee was set by the MMF Board of Directors on the basis of a study performed by Edgar, Dunn & Company ('EDC').\textsuperscript{48} Under the UK Domestic Rules MMF was required to consult with and give due regard to the views of both MCE and MCI before adopting a change to any of the fallback interchange fees (UK Domestic Rules, clause 4.7.1).

\textsuperscript{46} Data provided on 11 September 2000 in response to an OFT information request, dated 25 August 2000, made under section 26 of the CA98. A major part of UK transactions are processed by ECCSS.

\textsuperscript{47} An information request, dated 9 July 2004, to the main MasterCard acquirers in the UK made under section 26 of the CA98. Responses were received between July and October 2004.

\textsuperscript{48} The EDC cost study was first considered by a group of experts (the Interchange Sub-Group) drawn from members of MMF which made recommendations to the Board. On the processes involved in setting MMF’s MIFs, see: letter from Denton Wilde Sapte to the OFT (8 September 2000) in response to an OFT information request (3 August 2000); letter from Denton Wilde Sapte to the OFT (13 November 2000) in response to an OFT information request (13 October 2000); letter from Lovells to the OFT (23 January 2004) in response to an OFT information request made under section 26 of the CA98 (6 January 2004).
46. Cost studies were conducted by EDC every two years from 1993. MMF provided the OFT with the EDC cost study dated March 1998, which was based on 1997 data, and the EDC cost study dated September 2000, which was based on 1999 data. The most recent cost study was the 2002 Pay Later Domestic Interchange Study, Final Report (November 2002), based on 2001 data (the 'EDC 2002 Study').

47. EDC examined the costs to issuers of different categories of credit and charge card transactions as determined by the MMF Board. For each category averages for certain cost components were calculated by EDC on the basis of cost data for a twelve-month period provided by the larger issuers. These averages were then used to determine the average cost to the issuer.

48. The three (main) cost components that were taken into account by EDC were (i) the payment guarantee; (ii) funding for delayed payment – the interest-free period; and (iii) processing of incoming transactions.

   (i) The payment guarantee relates to two different scenarios: first, where the cardholder defaults and second, where the card or the card’s details are used fraudulently by a third party.\[49\]

   (ii) Funding for delayed payment concerns the costs to issuers of providing the deferred payment facility and is based on the number of interest-free days allowed by issuers to their cardholders.\[49\]

   (iii) Processing of incoming transactions relates to the receipt, balancing and settlement of the inward transactions, and also includes the cost of handling disputed transactions.

49. Although the MMF Board of Directors used the relevant EDC cost study as a basis for determining the level of different categories of fallback interchange fees, it could also take into account other non-cost related factors that might result in differences between the cost data provided by the relevant EDC study and the level of the fallback fees that were set. These included long-term trends in costs, market conditions, competition from other payment schemes, technological changes, regulatory issues and the need to incentivise certain behaviour to improve the efficiency of the scheme (for example the deployment of chip/PIN terminals).

50. The following Table sets out the categories of UK domestic fallback interchange fees and rates which have applied between March 2000 and November 2004. On 12 October 2001, separate categories and rates for transactions undertaken at \[REDACTED\] and for \[REDACTED\] came into effect.\[50\] The MMF Board then approved a number of changes to the level

\[49\] The payment guarantee against fraud did not apply in the case of remote transactions, such as mail order and telephone order transactions, where neither the validity of the card nor the identity of the cardholder could be verified.

\[50\] Letter from Denton Wilde Sapte to the OFT (18 January 2002); letter from Denton Wilde Sapte to the OFT (25 January 2002).
of UK domestic fallback interchange fees with effect from 1 October 2004, when the [REDACTED] was split into separate [REDACTED] and [REDACTED].

Table 2: UK domestic fallback interchange fees

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[REDACTED]</td>
<td>1.00%</td>
<td>1.00%</td>
<td>[0.76-1.00]%</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>1.10%</td>
<td>1.10%</td>
<td>[0.76-1.00]%</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>1.10%</td>
<td>1.10%</td>
<td>[1.01-1.25]%</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>1.10%</td>
<td>1.10%</td>
<td>[1.26-1.50]%</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>-</td>
<td>-</td>
<td>[0.76-1.00]%</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>-</td>
<td>-</td>
<td>[1.01-1.25]%</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>-</td>
<td>1.10%</td>
<td>[1.01-1.25]%</td>
</tr>
<tr>
<td>Standard</td>
<td>1.30%</td>
<td>1.30%</td>
<td>[1.26-1.50]%</td>
</tr>
</tbody>
</table>

THE MARKET POSITION OF MASTERCARD

51. MasterCard and Visa operate credit card, charge card and debit card schemes in the UK. Also, Amex and Diners have a significant share of charge card transactions, although the volume of charge card transactions is small relative to credit card transactions.

52. In 2004, there were 26.5 million UK-issued MasterCard credit cards which were used for 618 million purchase transactions in the UK at a total value of £35.7 billion; and 1.2 million UK-issued MasterCard charge cards which were used for 86 million purchase transactions in the UK at a total value of just over £7 billion. In 2004, MasterCard credit and charge cards accounted for 37 per cent of credit and charge cards in issue in the UK, 35 per cent of credit and charge card transactions by value in the UK (£42.7 billion) and 36 per cent of credit and charge card transactions by volume in the UK.

53. Tables 3-5 below are based on the APACS Plastic Card Review 2005, and provide data for the number of credit and charge cards in issue and

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51 Letter from Lovells to the OFT (17 May 2004).  
52 [REDACTED].  
53 [REDACTED].  
54 [REDACTED].  
55 [REDACTED].  
56 [REDACTED].  
57 A standard transaction is one that does not qualify for any of the other categories.  
58 See paragraph 3 above.  
the volume and value of credit and charge card purchase transactions in the UK between 2000 and 2004.\textsuperscript{60}

**Table 3:** Number of credit and charge cards in issue in the UK (000s)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>MC</td>
<td>16,383</td>
<td>18,079</td>
<td>19,203</td>
<td>25,284</td>
<td>27,735</td>
</tr>
<tr>
<td></td>
<td>32%</td>
<td>32%</td>
<td>30%</td>
<td>36%</td>
<td>37%</td>
</tr>
<tr>
<td>Visa</td>
<td>32,545</td>
<td>36,018</td>
<td>41,784</td>
<td>43,761</td>
<td>44,455</td>
</tr>
<tr>
<td></td>
<td>64%</td>
<td>64%</td>
<td>66%</td>
<td>61%</td>
<td>60%</td>
</tr>
<tr>
<td>Other</td>
<td>1,925</td>
<td>2,030</td>
<td>2,118</td>
<td>2,211</td>
<td>2,121</td>
</tr>
<tr>
<td></td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Total</td>
<td>50,853</td>
<td>56,127</td>
<td>63,105</td>
<td>71,256</td>
<td>74,311</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*APACS Plastic Card Review 2005, Table 1*

**Table 4:** Number of credit and charge card transactions on UK-issued cards – purchases in UK (millions)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>MC</td>
<td>468</td>
<td>508</td>
<td>519</td>
<td>583</td>
<td>704</td>
</tr>
<tr>
<td></td>
<td>32%</td>
<td>33%</td>
<td>31%</td>
<td>32%</td>
<td>36%</td>
</tr>
<tr>
<td>Visa</td>
<td>914</td>
<td>973</td>
<td>1,089</td>
<td>1,157</td>
<td>1,174</td>
</tr>
<tr>
<td></td>
<td>63%</td>
<td>62%</td>
<td>64%</td>
<td>64%</td>
<td>60%</td>
</tr>
<tr>
<td>Other</td>
<td>69</td>
<td>80</td>
<td>79</td>
<td>81</td>
<td>71</td>
</tr>
<tr>
<td></td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>Total</td>
<td>1,451</td>
<td>1,561</td>
<td>1,687</td>
<td>1,821</td>
<td>1,949</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*APACS Plastic Card Review 2005, Table 4A*

\textsuperscript{60} The Tables contain details for both consumer cards and business cards. The OFT does not consider, however, that the inclusion of business cards has a significant effect on its conclusions regarding the market position of MasterCard for consumer credit and charge cards in the UK. Table 7E of the *APACS Plastic Card Review 2005* provides details for MasterCard and Visa business credit and charge cards, including the number of cards in issue, and the volume and value of purchases and cash acquisitions in and outside the UK. However, the Table does not give separate information for purchases made in the UK on MasterCard and Visa business credit and charge cards issued in the UK from which figures specific to transactions made on consumer credit and charge cards can be calculated. Overall, MasterCard business cards in 2004 represented 3 per cent of MasterCard credit and charge cards in issue in the UK, and 7 per cent by volume and 9.4 per cent by value of all transactions (cash acquisitions and purchases) made on UK-issued MasterCard credit and charge cards both in and outside the UK.

\textsuperscript{61} Mainly Amex and Diners and largely charge cards, although Amex now issues a small number of credit cards (see paragraph 3 above). Japan Credit Bureau (‘JCB’) also issues credit/charge cards in the UK.
Table 5: Value of credit and charge card transactions on UK-issued cards – purchases in UK (£millions)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>MC</td>
<td>26,870</td>
<td>29,592</td>
<td>30,854</td>
<td>35,731</td>
<td>42,757</td>
</tr>
<tr>
<td>Visa</td>
<td>48,704</td>
<td>53,387</td>
<td>61,765</td>
<td>67,821</td>
<td>70,185</td>
</tr>
<tr>
<td>Other</td>
<td>9,341</td>
<td>10,632</td>
<td>10,491</td>
<td>9,853</td>
<td>9,852</td>
</tr>
<tr>
<td>Total</td>
<td>84,915</td>
<td>93,611</td>
<td>103,110</td>
<td>113,405</td>
<td>122,794</td>
</tr>
</tbody>
</table>

APACS Plastic Card Review 2005, Table 4B

54. In addition, Tables 6-7 below, based on the APACS Plastic Card Review 2005, provide details for transactions made on debit cards, as well as, credit and charge cards:
### Table 6: Number of plastic card transactions on UK-issued cards purchases in UK (millions)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MC (credit and charge)</strong></td>
<td>468</td>
<td>508</td>
<td>519</td>
<td>583</td>
<td>704</td>
</tr>
<tr>
<td></td>
<td>12.4%</td>
<td>11.9%</td>
<td>11.1%</td>
<td>11.2%</td>
<td>12.5%</td>
</tr>
<tr>
<td><strong>Visa (credit and charge)</strong></td>
<td>914</td>
<td>973</td>
<td>1089</td>
<td>1157</td>
<td>1,174</td>
</tr>
<tr>
<td></td>
<td>24.1%</td>
<td>22.9%</td>
<td>23.3%</td>
<td>22.3%</td>
<td>20.8%</td>
</tr>
<tr>
<td><strong>Other credit and charge cards</strong></td>
<td>69</td>
<td>80</td>
<td>79</td>
<td>81</td>
<td>71</td>
</tr>
<tr>
<td></td>
<td>1.8%</td>
<td>1.9%</td>
<td>1.7%</td>
<td>1.6%</td>
<td>1.3%</td>
</tr>
<tr>
<td><strong>Visa debit</strong></td>
<td>1,072</td>
<td>1,245</td>
<td>1,359</td>
<td>1,498</td>
<td>1,663</td>
</tr>
<tr>
<td></td>
<td>28.2%</td>
<td>29.3%</td>
<td>29.0%</td>
<td>28.9%</td>
<td>29.5%</td>
</tr>
<tr>
<td><strong>Visa Electron</strong></td>
<td>35</td>
<td>48</td>
<td>70</td>
<td>78</td>
<td>110</td>
</tr>
<tr>
<td></td>
<td>0.9%</td>
<td>1.1%</td>
<td>1.5%</td>
<td>1.5%</td>
<td>1.9%</td>
</tr>
<tr>
<td><strong>Maestro</strong>[^62]</td>
<td>1,193</td>
<td>1,334</td>
<td>1,476</td>
<td>1,653</td>
<td>1,760</td>
</tr>
<tr>
<td></td>
<td>31.6%</td>
<td>31.3%</td>
<td>31.5%</td>
<td>31.9%</td>
<td>31.2%</td>
</tr>
<tr>
<td><strong>Solo</strong></td>
<td>37</td>
<td>69</td>
<td>89</td>
<td>136</td>
<td>157</td>
</tr>
<tr>
<td></td>
<td>1.0%</td>
<td>1.6%</td>
<td>1.9%</td>
<td>2.6%</td>
<td>2.8%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>3,788</td>
<td>4,257</td>
<td>4,681</td>
<td>5,186</td>
<td>5,639</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

[^62]: Switch branded debit cards have recently migrated to the MasterCard Maestro brand, see footnote 7 above.
<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MC (credit and charge)</strong></td>
<td>26,870</td>
<td>29,592</td>
<td>30,854</td>
<td>35,731</td>
<td>42,757</td>
</tr>
<tr>
<td><strong>Visa (credit and charge)</strong></td>
<td>48,704</td>
<td>53,387</td>
<td>61,765</td>
<td>67,821</td>
<td>70,185</td>
</tr>
<tr>
<td><strong>Other credit and charge cards</strong></td>
<td>9,341</td>
<td>10,632</td>
<td>10,491</td>
<td>9,853</td>
<td>9,852</td>
</tr>
<tr>
<td><strong>Visa debit</strong></td>
<td>36,979</td>
<td>45,311</td>
<td>51,619</td>
<td>61,404</td>
<td>70,735</td>
</tr>
<tr>
<td><strong>Visa Electron</strong></td>
<td>1,004</td>
<td>1,391</td>
<td>1,691</td>
<td>2,195</td>
<td>3,226</td>
</tr>
<tr>
<td><strong>Maestro</strong></td>
<td><strong>36,919</strong></td>
<td><strong>46,093</strong></td>
<td><strong>51,651</strong></td>
<td><strong>62,102</strong></td>
<td><strong>69,997</strong></td>
</tr>
<tr>
<td><strong>Solo</strong></td>
<td>1,085</td>
<td>2,124</td>
<td>2,884</td>
<td>4,768</td>
<td>6,195</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>160,902</td>
<td>188,530</td>
<td>210,955</td>
<td>243,874</td>
<td>272,947</td>
</tr>
</tbody>
</table>

*APACS Plastic Card Review 2005, Table 4B*
B PROCEDURE

55. On 1 March 2000, MMF notified its Memorandum and Articles of Association ('M&AA's') and the UK Domestic Rules to the OFT ('the notification'). MMF applied for a decision that the prohibitions of Chapters I and II of the CA98 did not apply to the notified agreements or, to the extent that the OFT did find that the Chapter I prohibition of the CA98 (the 'Chapter I prohibition') was infringed, an individual exemption.

56. On 18 April 2000, MMF made a separate submission to the OFT in support of the notification. In this, MMF indicated its concern that Chapter 13 of the UK Domestic Rules on Interchange and Service Fee Programmes might be regarded as potentially giving rise to questions of compatibility with the Chapter I and/or Chapter II prohibitions of the CA98. The notification was deemed to be complete from this date.

57. On 1 September 2000, the British Retail Consortium (the 'BRC') submitted a complaint to the OFT under the Chapter I and II prohibitions of the CA98 against MMF, Visa UK Limited and Switch Card Services Limited (now S2). The BRC is the trade association of the retail industry representing more than 90 per cent of the total retail trade in the UK. According to the BRC, the complaint was prompted by the application of MMF for a decision under the CA98.

58. The BRC considered the collective establishment of MMF's fallback interchange fees to be an appreciable restriction of competition which infringed the Chapter I prohibition and did not qualify for an individual exemption. The BRC considered that merchants accepting MasterCard cards are directly affected by this alleged collective price fixing as the fallback interchange fees are passed on through their inclusion in an MSC by the merchant acquiring bank to the merchant who is unable to influence their level. As the merchant acquiring banks are also card issuing banks, there is little incentive to negotiate interchange fees to competitive levels. The BRC believes its members are, effectively, captive customers. The BRC also submitted that the imposition of the fallback interchange fee, payable ultimately by the merchant, is unjustified by any services offered to the merchant by the banks.

59. On 25 September 2001, the OFT issued a Rule 14 Notice ('R14') to MMF as the notifying party and to the UK licensees of MCE/MCI as parties to the UK Domestic Rules. The OFT subsequently issued the R14 to MCE and MCI, which had been added as parties to the UK Domestic Rules by MMF. The OFT also provided a non-confidential version of the R14 to Visa International.

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63 The M&AA's of MMF were adopted by a special resolution on 2 December 1992 and, prior to the notification, were last amended on 10 February 2000. Revised M&AA's were adopted by a special resolution dated 27 May 2002 and a copy was provided to the OFT in January 2003: letter from Denton Wilde Sapte to the OFT (24 January 2003).

64 When the UK Domestic Rules were revised in October 2002, MMF's arrangements for interchange and service fees were set out in Chapter 4 of the revised UK Domestic Rules on Interchange Processes and Fees.
60. The R14 set out the OFT’s provisional finding that MMF’s arrangements regarding fallback interchange fees and fallback service fees, in accordance with the UK Domestic Rules, infringed the Chapter I prohibition and did not qualify for an individual exemption.

61. Written representations on the R14 were received from MMF, MCE/MCI, MBNA Europe Bank Limited (‘MBNA’), HSBC Bank plc and The Royal Bank of Scotland Group (‘RBSG’). A submission was also received from Visa International. A joint oral representations meeting for MMF, MCE, MCI and UK licensees of MasterCard was held on 5 February 2002. On 6 February 2002, confidential oral representations meetings were held for RBSG and MBNA.

62. In February 2003, the OFT issued a Supplementary Rule 14 Notice (‘SR14’) to MMF, MCE, MCI and the UK licensees of MCE/MCI at that time. The SR14 set out the OFT’s provisional finding that MMF’s arrangements regarding fallback interchange fees, in accordance with the UK Domestic Rules, as regards transactions made in the UK by means of consumer credit and charge cards infringed the Chapter I prohibition and did not qualify for an individual exemption. The SR14 did not consider MMF’s arrangements regarding fallback interchange fees for transactions made in the UK by means of business credit and charge cards or MMF’s arrangements regarding fallback service fees, in accordance with the UK Domestic Rules.65

63. Joint written representations on the SR14 were made by MMF, MCE and MCI. Individual written representations were received from MBNA, Goldfish Bank Limited, HSBC plc and RBSG. A joint oral representations meeting for MMF, MCE, MCI and UK licensees of MasterCard was held on 21 May 2003. On 22 May 2003, a confidential oral representations meeting was held for RBSG.

64. The OFT also provided a non-confidential version of the SR14 to Visa International, who submitted comments dated 16 May 2003.

65. As a result of the coming into force of the Modernisation Regulation on 1 May 2004, the notification made by MMF lapsed as from the date of application of this Regulation.66 The OFT continued to investigate MMF’s arrangements regarding fallback interchange fees, in accordance with the UK Domestic Rules, even though the notification had lapsed. The Modernisation Regulation requires the OFT to apply Article 81 and/or Article 82 of the EC Treaty when it applies national competition law to agreements or conduct that may affect trade between Member States within the meaning of Article 81(1) and/or Article 82 of the EC Treaty as

65 Subsequent to the issue of the R14, the fallback service fee for a cash advance using an ATM was reduced from £[1.00-1.50] to £[0-0.50] per advance, while the fallback service fee for a manual cash advance in a bank branch was increased from £[2.00-2.50] to £[3.50-4.00] per advance. The new fallback service fee rates were set out in clause 4.7.1 of the UK Domestic Rules (October 2002).

66 Article 34(1) of the Modernisation Regulation (EC Regulation 1/2003).
appropriate. The investigation by the OFT therefore considered the application of Article 81 of the EC Treaty ('Article 81') as well as the Chapter I prohibition to MMF’s fallback interchange fee arrangements, in accordance with the UK Domestic Rules, as regards transactions in the UK made by means of consumer credit and charge cards.

66. In November 2004, the OFT issued a Statement of Objections ('SO') to MMF, MCE, MCI and the UK licensees of MCE/MCI at that time. The SO set out the OFT’s provisional finding that MMF’s fallback interchange fee arrangements, in accordance with the UK Domestic Rules, as regards transactions in the UK made by means of consumer credit and charge cards infringed Article 81(1) and the Chapter I prohibition, and did not qualify for exemption under Article 81(3) and section 9 of the CA98.

67. Joint written representations on the SO were made by MMF, MCE and MCI. Individual written representations were received from MCI, RBSG and Lloyds TSB Bank plc. On 2 March 2005, a joint oral representations meeting was held for MMF, MCE, MCI and UK licensees of MasterCard, and a confidential oral representations meeting for [REDACTED].

68. A non-confidential version of the SO was provided to Visa Europe and the BRC. Amex was provided with that section of the SO dealing with 'The requirements of Articles 3 and 16 of the Modernisation Regulation, section 60 of the CA98 and the OFT’s obligations under Community Law'. Visa Europe, the BRC and Amex made submissions to the OFT.

69. This Decision concerns the application of Article 81 and the Chapter I prohibition to MMF’s fallback interchange fee arrangements, in accordance with the UK Domestic Rules, as regards transactions made in the UK by means of consumer credit and charge cards between 1 March 2000 and 18 November 2004 (i.e. the MMF MIF agreement). The Decision does not address the arrangements for fallback interchange fees put in place by the [REDACTED] on 18 November 2004. The OFT has not examined these new arrangements and is therefore unable to express a view as to whether these comply with competition law.

70. The Decision does not consider the application of Article 81 or the Chapter I prohibition to MMF’s arrangements regarding fallback interchange fees for transactions made in the UK by means of business credit and charge cards or MMF’s arrangements regarding fallback service fees, in accordance with the UK Domestic Rules, during the period 1 March 2000 to 18 November 2004.

71. Also, the decision does not consider the application of Article 81 or the Chapter I prohibition to the M&As of MMF, or any other provisions in the UK Domestic Rules or to any of the other rules applicable to UK domestic transactions (as defined in the UK Domestic Rules).

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67 See paragraphs 32-35 above.
72. The OFT has informed the European Commission ('the Commission') of this decision in accordance with Article 11(4) of the Modernisation Regulation.\textsuperscript{68}

\textsuperscript{68} EC Regulation 1/2003.
II LEGAL AND ECONOMIC ASSESSMENT

A THE REQUIREMENTS OF ARTICLES 3 AND 16 OF THE MODERNISATION REGULATION, SECTION 60 OF THE CA98 AND THE OFT’S OBLIGATIONS UNDER COMMUNITY LAW

SUMMARY

73. In 2002, the Commission adopted the Visa International – Multilateral Interchange Fee decision (‘the Visa MIF decision’) granting an individual exemption to the modified Visa intra-regional MIF scheme, as applied to cross-border POS transactions with Visa consumer cards within the European Economic Area (‘EEA’).

74. Visa and Amex have argued that, as a result of section 60 of the CA98 and/or Community law, the OFT is obliged to conclude that the UK Domestic Rules are exempt from Article 81(1) and the Chapter I prohibition, provided that similar conditions to those laid down by the Commission in its decision on the Visa intra-regional MIF are applied to the operation of the UK Domestic Rules. The Parties made similar arguments at a relatively early stage in the proceedings but, in submissions in response to the SR14 and the SO, urge the OFT to depart from certain of the Commission’s findings, while criticising the OFT for failing to justify departing from other elements of the Commission’s reasoning.

75. For the reasons explained in this Section and (as regards specific issues) elsewhere in this Decision, the OFT takes the view that neither Community law, nor section 60 of the CA98 requires it, in light of the Commission’s decision on the Visa intra-regional MIF, to decide that the MMF MIF agreement69 is exempt from Article 81(1) and the Chapter I prohibition. In addition, the OFT considers that, where in this Decision it has taken a different approach from that taken by the Commission in the Visa MIF decision to specific issues, it has fully justified doing so.

BACKGROUND

The Commission’s Visa International proceedings

76. On 11 August 2001, the Commission published a Notice in Case Comp/29.373 Visa International pursuant to Article 19(3) of Regulation 17/62 in the Official Journal of the European Communities (the ‘Article 19(3) Notice’)70 proposing to adopt a favourable position in respect of the modified Visa EU intra-regional MIF scheme.

77. On 24 July 2002 the Commission adopted the Visa MIF decision granting an individual exemption to the modified Visa intra-regional MIF scheme as

69 In the remainder of this Decision, the MMF MIF agreement (although now at an end) is discussed in the present tense.
applied to cross-border POS transactions with Visa consumer cards within the EEA. The _Visa MIF_ decision was published in the Official Journal on 22 November 2002.\(^{71}\)

78. The Modernisation Regulation was adopted on 16 December 2002 and entered into force on 1 May 2004.

79. In its _Visa MIF_ decision, the Commission found that the EU intra-regional MIF in the Visa system restricted and distorted competition within the meaning of Article 81(1) by restricting the freedom of financial institutions individually to decide their own pricing policies. The Commission found moreover that the Visa system's MIF had a restrictive effect on competition among Visa acquirers and among Visa issuers.\(^{72}\) However, the Commission decided that the modified Visa MIF arrangements fulfilled the conditions for exemption under Article 81(3), and so granted an individual exemption which will remain in force until 31 December 2007.\(^{73}\)

80. The conditions placed on the grant of the exemption include the following:

(i) Under the modified arrangements, (a) the yearly weighted average of the different MIF levels for debit cards is not to exceed Euro 0.28 for 5 years, save in the event of a significant change in issuers’ costs, and (b) the MIF rates for transactions on credit and deferred debit cards is to be reduced over a 5-year period, leaving the weighted average MIF at not more than 0.7 per cent by 2007 according to Visa’s estimates of transaction volumes at that date.\(^{74}\)

(ii) The effective level of the MIF is to be calculated on the basis of regular cost studies, audited by an independent firm of accountants, and, other than in exceptional circumstances, it must be based on and may not exceed: (i) the cost of processing transactions; (ii) the cost of the free-funding period for cardholders; and (iii) the cost of the payment guarantee against fraud and cardholder default.\(^{75}\)

**Points of similarity with the _Visa MIF_ Decision**

81. On many key points, there is considerable similarity between the reasoning relied on, and conclusions reached, by the OFT in this Decision and the reasoning and conclusions of the Commission in the _Visa MIF_ decision.


\(^{72}\) Paragraph 64, _Visa MIF_ decision.

\(^{73}\) Paragraphs 107 and 109, _Visa MIF_ decision. Decisions adopted by the Commission pursuant to Article 81(3) prior to 1 May 2004 remain in force until the date of expiry of the decisions: see Article 43(1) of the Modernisation Regulation.

\(^{74}\) Paragraphs 16–20, 107 and Articles 1.1, 2.2, _Visa MIF_ decision.

\(^{75}\) The Commission found the inclusion of only _some_ of the costs of the guarantee against cardholder default in the Visa cross-border MIF to be justifiable. See paragraph 647 below.
82. For example, the OFT has considered whether competition from other payment mechanisms (inter-system competition) would prevent the MMF MIF being increased above the competitive level. This is similar to the Commission's examination of potential for competition at both the intra-system and inter-system level in its Visa MIF decision.\textsuperscript{76} In addition, the Commission’s Visa MIF decision reaches similar conclusions on the recovery of the costs of the guarantee against cardholder default and the guarantee against fraud through the Visa MIF.

83. Therefore, it is certainly not the case (as has been argued\textsuperscript{77}) that the OFT has rejected the Commission’s analysis in the Visa MIF decision out of hand.

THE OFT’S VIEW

Community law

84. The OFT takes the view that no principle or provision of Community law requires it to decide that the MMF MIF agreement is exempt from Article 81 and the Chapter I prohibition because of the Commission’s Visa MIF decision.

85. Article 10 of the EC Treaty is the source for the general duty of ‘sincere cooperation’. This provides:

“Member States shall take all appropriate measures, whether general or particular, to ensure fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community’s tasks. They shall abstain from any measure which could jeopardise the attainment of the objectives of this Treaty.”

86. In the field of application of the Community rules on competition, the duty of sincere co-operation between national and Community institutions now finds specific expression in Articles 3 and 16, and also Article 11, of the Modernisation Regulation.

87. Article 3(2) of the Modernisation Regulation states (so far as material):

“The application of national competition law may not lead to the prohibition of agreements...which may affect trade between Member States but which do not restrict competition within the meaning of Article 81(1) of the Treaty or which fulfil the conditions of Article 81(3) of the Treaty...”

\textsuperscript{76} Paragraphs 43-45, Visa MIF decision.

\textsuperscript{77} Visa submission (25 February 2005).
88. Article 16(2) of the Modernisation Regulation states:

"When competition authorities of the Member States rule on agreements, decisions or practices under Article 81 or Article 82 of the Treaty which are already the subject of a Commission decision, they cannot take decisions which would run counter to the decision adopted by the Commission."

89. Article 11 of the Modernisation Regulation provides for close cooperation between national competition authorities ('NCAs') and the Commission in applying the Community competition rules. The NCA informs the Commission of its envisaged enforcement decisions under Article 11(4). According to Article 11(6), if then the Commission initiates proceedings in the case, the NCA is relieved of its competence.

90. So far as Article 3(2) is concerned, the OFT considers that the MMF UK Domestic Rules have the potential appreciably to affect trade between Member States, with the result that Article 81 applies to them in addition to the Chapter I prohibition. In this Decision, the OFT applies Article 81 to the agreement as well as national competition law (in accordance with Article 3(1) of the Modernisation Regulation), and the conclusions in each case are consistent. This is not, therefore, a case where the application of national competition law prohibits an agreement that is exempt from the prohibition in Article 81(1), or vice versa.

91. So far as Article 16(2) is concerned, it is first important to stress the factual distinctions between the arrangements which were the subject of the Visa MIF decision, and the arrangements in the present case. The arrangements that are under consideration in the present case apply in the UK to domestic transactions carried out under the MasterCard scheme in respect of credit and charge card products. The arrangements that were the subject of the Commission’s Visa MIF decision were different. These arrangements concerned different parties and the Commission was concerned solely with the application of Article 81 to the Visa interchange fee as applied to cross-border Visa card payment operations between EEA States. Thus the Commission in the Visa MIF decision did not purport to answer any question about the justifiability of MIFs which might apply to domestic transactions. Indeed, at paragraph 9 of the Visa MIF decision, the Commission stated:

"...the present decision relates only to the notified intra-regional interchange fee of Visa as applied to cross-border Visa card payment operations between EEA Member States, not to any domestic interchange fees set by national Visa Members, nor to any application of the intra-regional interchange fee of Visa to domestic Visa card payment operations within a Member State...."  

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78 See paragraphs 358-371.
79 See also Article 1.1 and paragraph 8 of the Article 19(3) Notice. IP/02/1138 of 24 July 2002 stated that “The decision does not apply to MIFs for domestic Visa payments within Member States...The assessment of the exemptability of the reformed Visa MIF
92. It follows that the agreement which is the subject of the present Decision is therefore not “already the subject of a Commission decision” for the purposes of Article 16(2).

93. Even if the duty of sincere co-operation based on Article 10 of the EC Treaty imposes obligations on the OFT going beyond the terms of Article 3 and Article 16 of the Modernisation Regulation (and it is not clear that it does), there is no merit in the argument that a decision of infringement in this separate case would prejudice the full and uniform application of Community law or the effects of measures taken or to be taken to implement Community law. This is because, in deciding that the Visa MIF arrangements merited an individual exemption under Article 81(3), the Commission’s reasoning relied on facts and circumstances that were, it noted, of particular significance in the context of international card payments:

(i) In relation to the payment guarantee element in the revised Visa MIF, the Commission found that this was a kind of insurance premium which was of particular importance in the context of international card payments:

“In general, retailers benefit from a ‘payment guarantee’ because without it they would have few means of obtaining payment from Visa cardholders from other Member States in the case of fraud or insolvency. Fraud in particular is much higher for cross-border transactions than for domestic ones. No evidence has been provided to the Commission to suggest that in the absence of a payment guarantee, insurance against fraud and credit losses linked to international card payments would be widely available to retailers, or if so, that it would be available on terms affordable to medium-sized and small retailers.”

(ii) In relation to the cost element of the payment guarantee relating to cardholder default, the Commission specifically relied upon the fact that:

“[insurance against cardholder’s insolvency] …would be likely to be particularly expensive for cross-border payments, as the recovery of debts is more difficult in a cross-border context than domestically. The risk of default is also higher in a cross-border context, since cardholders with a history of defaulting are particularly likely to

was carried out by the Commission in the context of cross-border payments within the Visa payment scheme only. An assessment of MIFs for domestic payments, or in different payment systems than Visa, would have to be made in the light of the different market conditions applicable to such cases. In particular, the question of what constitutes a reasonable and equitable MIF might be answered differently in different circumstances”.

80 Paragraph 86, Visa MIF decision.
carry out purchases abroad, where they are less likely to be on any default 'black lists'”.\textsuperscript{81}

(iii) In relation to the costs associated with the interest-free period, the Commission relied on the perceived beneficial cross-border effects of including this element in the Visa MIF:

“While it is not proven that this facility increases total aggregate consumption, it is plausible that it may well stimulate cross-border purchases by cardholders travelling abroad, who usually do not have the means to check their account balance and cannot delay their purchase to later. Without the free-funding period, cardholders travelling abroad are likely to be more prudent with regard to their overall spending for fear of taking their account into the red. Whilst this phenomenon may have a neutral overall effect on total consumption in Europe, it nevertheless facilitates and encourages cross-border spending as opposed to domestic spending. In this light the inclusion of the free-funding period in a MIF for cross-border purchases can be justified, primarily as it benefits merchants with whom such purchases are made, but also as it promotes cross-border purchases within the single market.”\textsuperscript{82}

(iv) In relation to the question of indispensability of the Visa MIF arrangements for the achievement of identified benefits, the Commission laid emphasis upon the international nature of the arrangements under consideration:

“In this regard the Commission takes into account that it has not been established that there are examples of an international credit or deferred debit card scheme that functions without an MIF. While the various domestic payment systems referred to by EuroCommerce...all have points of similarity with the Visa system, they also have differences, which preclude any useful comparison...”\textsuperscript{83}

94. In these circumstances, an infringement decision by the OFT in relation to the domestic MMF MIF agreement does not undermine the effectiveness of the exemption granted by the Commission in the Visa MIF decision (nor, indeed, any decision which may, in the future, be made by the

\textsuperscript{81} Paragraph 87, Visa MIF decision.
\textsuperscript{82} Paragraph 89, Visa MIF decision.
\textsuperscript{83} Paragraph 100, Visa MIF decision. See also footnote 45 of the Visa MIF decision, where the Commission remarked that in a domestic context the number of banks may well be far fewer and the efficiency gains of a multilateral arrangement vis-à-vis bilateral agreements may not outweigh the disadvantage of the creation of a restriction of competition. See also the Commission’s press release of 24 July 2002 (referred to in footnote 79 above and 87 below), which advocated a case by case approach.
Commission in relation to the MIF that applies to cross-border transactions in the MasterCard scheme).\textsuperscript{84}

95. As noted at paragraph 72 above, the OFT has complied with the requirements of Article 11 of the Modernisation Regulation as regards cooperation and coordination with the Commission. The Commission was notified of the OFT’s envisaged decision, in accordance with Article 11(4). The Commission did not initiate proceedings with a view to the adoption of a decision of its own regarding the facts under investigation by the OFT, as might have been expected had there been a failure to respect the duty of sincere cooperation, as alleged by the parties.

Section 60 of the CA98

96. Section 60 of the CA98 provides as follows, so far as material:

\begin{quote}
\textit{“(1) The purpose of this section is to ensure that so far as is possible (having regard to any relevant differences between the provisions concerned), questions arising under this Part in relation to competition within the United Kingdom are dealt with in a manner which is consistent with the treatment of corresponding questions arising in Community law in relation to competition within the Community.}

\textit{(2) At any time when the court determines a question arising under this Part, it must act (so far as is compatible with the provisions of this Part and whether or not it would otherwise be required to do so) with a view to securing that there is no inconsistency between:

\begin{enumerate}
\item [(a)] the principles applied, and decision reached, by the court in determining that question; and
\item [(b)] the principles laid down by the Treaty and the European Court, and any relevant decision of that Court, as applicable at that time in determining any corresponding question arising in Community law.
\end{enumerate}

\textit{(3) The Court must, in addition, have regard to any relevant decision or statement of the Commission.}

\textit{(4) Subsections (2) and (3) also apply to …(a) the OFT…”}
\end{quote}

\textsuperscript{84} The Commission is also considering the MCE and MCI rules that govern European cross-border transactions in the MCE/MCI card payment system. See further paragraph 2.1.2, MCE/MCI’s joint submission in response to Rule 14 Notice, 23 January 2002 and the Commission’s press release IP/04/616 of 7 May 2004. The Commission’s case does not cover the UK Domestic Rules, which contain the MMF MIF agreement that is the subject of this Decision. These were only notified to the OFT.
Corresponding questions

97. Section 60 of the CA98 applies where questions arising in relation to competition within the UK, faced by the OFT, correspond to questions arising in relation to competition within the Community, which have arisen in Community law.

98. As MMF itself points out, to the extent that there are “relevant differences” between the facts and circumstances considered by the Commission at the cross-border level in the Visa MIF decision on the one hand, and the facts and circumstances under consideration by the OFT in relation to MMF’s intra-UK arrangements on the other hand, there will not be “corresponding questions” for the purposes of section 60. Visa also accepts that the OFT will not be faced with “corresponding questions” where there is a difference in the facts before the OFT and the facts that were before the Commission which would be “material to the application of the competition rules”.

99. There are indeed differences in the facts and circumstances, and the OFT is faced in many (but not all) respects with different questions in relation to competition from the questions considered by the Commission in the Visa MIF decision.

100. First, and as noted above in paragraphs 91-92, it is plain from the Visa MIF decision that the Commission was concerned solely with the application of Article 81 to a cross-border payment system, and that it did not purport to answer any question about the justifiability of MIFs which might apply to domestic transactions.

101. Visa points out, and the OFT accepts, that the mere fact that one case involves competition in the UK, and the other involves competition within the Community, is not of itself a material difference for the purposes of determining whether “corresponding questions” arise. Equally, the OFT accepts that the fact that the Visa MIF decision was not addressed to domestic MIFs does not of itself mean that it did not address corresponding questions to those addressed in this Decision. However, it is clear from the Visa MIF decision that the Commission’s conclusions were materially influenced by the fact that it was concerned only with credit cards being used as cross-border payment instruments.

102. It follows that, at least with respect to issues similar to those referred to at paragraph 93 above as they arise in the domestic context in the present case (in particular, the justifiability of recovering all the costs of the

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85 Paragraphs 1.7-1.9, Letter from Denton Wilde Sapte to the OFT (29 November 2001).
86 See paragraph 14, Visa submission (16 May 2003) and paragraph 3.1(a), Visa submission (25 February 2005).
87 See paragraph 9 and Article 1.1 of the Visa MIF decision and also IP/02/1138 of 24 July 2002.
88 It follows that Visa and Amex misunderstand the OFT’s arguments in this regard (see paragraph 3.21(b), Visa submission (25 February 2005) and paragraph 25, Amex submission (4 February 2005)).
payment guarantee and of the free-funding period through the MMF MIF),
the "questions...in relation to competition" which are faced by the OFT do not correspond to those that were faced by the Commission in its cross-border Visa MIF decision.

103. Visa argues that, before the OFT can differ from a Commission decision on the grounds that it does not address corresponding questions, it must make findings, by reference to clear evidence, not only that a difference in the facts and circumstances considered by the Commission, and those considered by the OFT, exists but also that the nature of the difference has a material bearing on the proper analysis of the case. In order to assess this, Visa maintains that the OFT must examine the underlying facts and rules (i.e. those not specifically mentioned in the Visa MIF decision) to which the Commission had to have regard. The OFT does not accept that this is what section 60 of the CA98 (or any principle to be found in Community law) requires. Where the Commission's Visa MIF decision itself identifies facts or considerations which are particular to the cross-border context (except when addressing whether or not the agreement had an effect on inter-state trade for the purpose of finding jurisdiction), this is sufficient to allow the OFT to conclude that the Commission was not addressing corresponding questions. The OFT is entitled to assume, in the absence of an express contrary indication, that a Commission decision will not make reference to facts which are irrelevant or immaterial to the conclusions reached in the decision.

104. Secondly, it is clear that the Commission in the Visa MIF decision took into account 'single market' considerations in its decision to grant an exemption to the modified Visa MIF arrangements: in relation to the justifiability of including the cost of the free-funding period in the calculation of the Visa MIF, Visa apparently argued that this encouraged cardholders to increase their consumption, thereby benefiting merchants. While the Commission decided that this contention was not proven, it still considered the recovery of the cost of the free-funding period through the Visa MIF to be justified, on the grounds, inter alia, that it "facilitates and encourages cross-border spending as opposed to domestic spending" and thereby "promotes cross-border purchases within the single market".

105. Visa suggests that 'single market' is here used merely as a synonym for 'European Union'. This may be so, but that does not detract from the point that the Commission made a clear finding that promoting cross-border purchases within the single market was a benefit that it could take into account under Article 81(3), notwithstanding that there may be no overall effect on EU consumption.

106. While 'single market' considerations, in that sense, may well have been relevant in the context of applying Article 81(3) to the Visa interchange fee as applied to cross-border Visa card payment operations between EEA

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89 See paragraphs 12-16, Visa submission (16 May 2003).
90 See paragraph 3.21(b), Visa submission (25 February 2005).
91 Paragraph 89, Visa MIF decision (set out at paragraph 93(iii) above).
92 See paragraph 21, Visa submission (16 May 2003).
States, they are not relevant to the application by the OFT of the conditions for exemption laid down in Article 81(3) or section 9 of the CA98 in the present case, which is concerned solely with UK domestic transactions. To that extent, therefore, the Commission was not considering a corresponding question to that facing the OFT.

**The duty to have regard to any relevant decision or statement of the Commission**

107. Even where there are corresponding questions faced by the OFT (and where there are no relevant differences between the provisions concerned) it is clear that section 60 does not impose on the OFT any absolute constraint to follow relevant decisions or statements of the Commission.

108. Whereas section 60(2) of the CA98 requires the OFT (and the court) to act “with a view to securing that there is no inconsistency” between any decision reached on a question in relation to competition in the UK and any relevant decision of the European Court on a corresponding question in relation to competition within the Community, the legislature has deliberately framed section 60(3) of the CA98 in different terms. Section 60(3) implements the statutory purpose stated in section 60(1) by imposing a duty to “have regard” to any relevant decision or statement of the Commission.

109. On an ordinary interpretation, this means that while the OFT or a court must consider any relevant decision or statement of the Commission and accord it due weight, they are nevertheless free to depart from it in a proper case.

110. This is accepted by both MMF and by Visa (at least in its most recent submissions):

(i) MMF concedes that on the plain meaning of the words in section 60(3), the OFT’s duty to have regard to relevant Commission decisions “does not impose upon [it] an absolute duty to follow such decisions”.

(ii) Visa acknowledges that the OFT is free not to follow an earlier Commission decision “where [the OFT] has, and has stated that, it has clear and good reasons for so departing.” Thus, even where the OFT is faced with “corresponding questions” to those

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93 In paragraph 24 of its submission (16 May 2003), Visa denies that its previous arguments were to the effect that the Visa MIF decision represents an “absolute constraint” or a requirement that the OFT must “slavishly follow”, but nonetheless made clear that, on its then preferred interpretation of section 60, no significance is to be attributed to the different formulations in subsections 60(2) and (3): “…in circumstances where the [Visa MIF decision] sets out a recent, reasoned decision of principle and application of principle to similar facts, the [OFT] must so far as possible seek to achieve consistency with it.”

94 Paragraph 1.6, Letter to the OFT from Denton Wilde Sapte (29 November 2001).

95 Paragraph 3.21(c), Visa submission (25 February 2005)
considered by the Commission, and there are no “relevant differences” between the provisions of law concerned, Visa accepts that the OFT may depart from an earlier Commission decision such as the Visa MIF decision if it has “…clear and good reasons to depart from the principles of the [decision] and has stated such reasons.”

111. Amex, however, maintains that, by virtue of section 60(3), read with section 60(1), the OFT is bound to follow previous Commission decisions, such as the Visa MIF decision, where it addresses “corresponding questions”.

112. The OFT does not accept this argument.

113. As noted above, there is a clear distinction between the ‘weak’ wording of section 60(3) and the ‘strong’ wording of section 60(2). Had the legislature intended to achieve the result which Visa and Amex suggest in relation to relevant Commission decisions and/or statements, it could have readily provided for it by extending the categories of situation listed in section 60(2) in which it is necessary for the OFT or the court to act “with a view to securing that there is no inconsistency”. It chose not to, preferring instead to provide that the extent of the duty required to fulfil the statutory purpose in section 60(1) in the case of a relevant Commission decision is to “have regard” to it.

114. It has been argued that the weaker wording of section 60(3) can be explained on the basis that its scope is wider than that of section 60(2), since it applies to relevant Commission decisions and statements generally. The argument is that it would not have been appropriate to make general Commission statements (such as Commission Notices) binding in the same way as a legal principle established by the European Courts and so weaker wording was needed.

115. The OFT acknowledges that section 60(3) covers a range of Commission acts. Therefore, the weight that it is appropriate for the OFT to attach to them will vary depending on the nature of the Commission decision or statement (for example, whether it is of specific or general application) and the degree of reasoning it contains. The fact remains that the legislation only requires the OFT to have regard to such decisions or statements, whatever their nature; no matter how pertinent the decision or statement might be in relation to the question under consideration, the OFT is never absolutely constrained by it to reach a particular result.

116. Accordingly, the OFT has concluded that its duty under section 60(3), when faced with a question arising under Part I of the CA98 in relation to competition within the UK, is to give serious consideration to any relevant decision or statement of the Commission on a corresponding question.

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96 Paragraphs 3.1(a)-(b), 3.21(d) and 3.22-3.25, Visa submission (25 February 2005).
97 See also paragraph 34, Visa submission (16 May 2003).
98 Paragraphs 8.4-8.9, Visa submission (8 July 2002).
However, the OFT does not accept that this should override the ordinary meaning of the words to “have regard” so that it is bound, by section 60(3), to follow such decisions and statements.

FURTHER OBSERVATIONS ON THE ARGUMENTS RAISED BY THE PARTIES, VISA AND AMEX

MMF

117. MMF accepts that, in principle, (i) the OFT may be entitled to depart from decisions of the Commission or judgments of the European Court if these decisions are based on ‘single market’ considerations; and (ii) any factual differences between the circumstances of the case considered by the Commission and those of the matter under consideration by the OFT go to the question of whether or not the matter before the OFT is a “corresponding question”.\(^99\) Furthermore, it concedes that on the plain meaning of the words in section 60(3), the OFT’s duty to have regard to relevant Commission decisions “does not impose upon [it] an absolute duty to follow such decisions”.\(^100\)

118. MMF has urged the OFT to come to different conclusions as regards the relevant market and the issue of whether the MMF MIF agreement appreciably prevents, restricts or distorts competition for the purposes of Article 81(1) and the Chapter I prohibition from those reached by the Commission in the Visa MIF decision. Presumably, therefore, MMF would consider that the OFT should not, in any event, have followed the Commission’s conclusions on these points:

(i) MMF has stated that the only relevant market in which the effect of the MMF MIF agreement should be assessed is a market for methods of payment which includes all credit cards, store cards, charge cards, debit cards, cash and cheques.\(^101\) As noted below,\(^102\) the Commission, in its Visa MIF decision took as the relevant inter-system market a market comprising all types of payment card. While the Commission did not rule out that separate relevant product markets might exist as between different types of payment card, it did expressly rule out inclusion of cash and cheques within the relevant product market.\(^103\)

(ii) MMF has asserted that, in finding in the Visa MIF decision that the Visa cross-border MIF has the effect of restricting competition, the

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\(^99\) See footnote 5 and paragraph 1.5, Letter to the OFT from Denton Wilde Sapte on behalf of MMF (29 November 2001).

\(^100\) Paragraph 1.6, Letter to the OFT from Denton Wilde Sapte (29 November 2001).

\(^101\) Paragraph 3.52, MMF/MCI/MCE Joint written representations on the SO (17 February 2005) (‘Joint written representations on the SO’). These written representations on the SO were made by MMF, MCI and MCE jointly. For simplicity, in the remainder of this Decision these representations are attributed to MMF only.

\(^102\) See paragraph 333 below.

\(^103\) Visa MIF decision, paragraphs 46 to 52.
Commission erred, by reference to the case-law of the European Court.104

119. MMF has nonetheless criticised the OFT for failing to provide justifications for departing (as MMF saw it) from the approach of the Commission in the Visa MIF decision as regards assessing whether or not the MMF MIF agreement meets the criteria for exemption.105

120. MMF’s specific arguments in this regard, concerning assessing consumer benefits for the purposes of the second exemption condition and concerning justifications for recovering through the MMF MIF both the costs of the payment guarantee against cardholder default and the costs of the interest-free period, are mainly considered in the relevant sections of the Decision below.106 It is appropriate to note here, however, the following points:

(i) If these arguments lead MMF to maintain, in the context of the assessment of the exemption criteria, that the OFT must follow the Commission’s Visa MIF decision insofar as it addresses “corresponding questions”107 this is inconsistent with the position it has otherwise advanced.

(ii) The OFT could not, in any event, accept such an argument, for the reasons outlined at paragraphs 90-95 and 107-116 above.108

(iii) MMF has contended that, as regards the guarantee against cardholder default, the aspects of the Commission’s reasoning which rely on facts and circumstances of particular significance in the context of international card payments (see paragraph 93 above) go only to the quantity of cost that might be legitimately recovered through a domestic MIF (rather than, presumably, the categories of cost).109 This ignores, however, that the assessment that has to be carried out under Article 81(3) and section 9 of the CA98 is, in part, a quantitative assessment, involving weighing up the benefits of an agreement against the detriments it causes to competition. It also ignores that, in deciding that the arrangements before it met the criteria for exemption, the Commission was not considering particular elements in isolation: rather it was considering the whole package of modifications that had been proposed by

104 Paragraphs 4.4.28-4.4.29, MMF/MCI/MCE Joint written representations on the SR14 (2 May 2003) (‘Joint written representations on the SR14’). These written representations on the SR14 were made by MMF, MCI and MCE jointly. For simplicity, in the remainder of this Decision these representations are attributed to MMF only.
105 Paragraphs 5.69 and 5.85-5.90, Joint written representations on the SO.
106 See paragraphs 657-665 and 709-721 below.
107 See (in particular) paragraph 5.90, Joint written representations on the SO.; “…the OFT cannot depart from the Commission’s finding that the costs of the interest-free period are not extraneous without clear grounds for doing so…”
108 See also footnote 122 below.
109 Paragraphs 5.87 to 5.88, Joint written representations on the SO.
Visa, including reductions in the MIF and the publication of MIF levels.110

Visa and Amex

121. Visa has argued that, as a matter of Community law (and, in particular, by virtue of Article 10 of the EC Treaty and Article 16(2) of the Modernisation Regulation), the OFT is bound to apply the principles of the Visa MIF decision (including as to matters of economic assessment), unless it can establish that the facts relevant to MMF’s domestic MIF are materially different from those considered by the Commission in relation to the Visa cross-border MIF and that any such material factual differences justify the OFT in reaching a different conclusion in relation to the application of Article 81(3) and section 9 of the CA98.

122. In particular, Visa has asserted that:

(i) It follows from the principle of supremacy of Community law and the objective of ensuring its consistent application that the OFT has a duty under Community law to avoid taking conflicting decisions on matters whose facts bear strong similarities to those of cases which are the subject of a Commission decision.111

(ii) None of the following amount to materially different facts justifying the OFT reaching a different conclusion from that of the Commission in its Visa MIF decision: the involvement of different parties (MasterCard rather than Visa); concern with domestic, rather than cross-border transactions; that the Commission applied the relevant principles in the context of, and in particular to, cross-border transactions.112

(iii) Article 3 of the Modernisation Regulation limits the ability of the OFT to apply stricter national laws to agreements or practices that have received an exemption under Article 81(3).113

(iv) The OFT has materially misunderstood the features of the Visa cross-border MIF arrangements approved by the Commission in the Visa MIF decision and has failed to appreciate that much of the analysis and many of the findings in the decision apply, and were intended to apply “to MIFs generally”.114

(v) It is therefore not open to the OFT to depart from the Commission’s reasoning and to adopt its own divergent analysis of the relevant

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110 See second bullet-point of paragraph 39 of the Visa MIF decision. See also paragraphs 132 and 133 below.
111 Paragraphs 4 and 41-52, Visa submission (16 May 2003).
112 Paragraph 3.1(c), Visa submission (25 February 2005).
113 Paragraphs 4 and 50-52, Visa submission (16 May 2003).
114 Paragraphs 1.4(b), 2.4, 4.7, 5.1(b) and footnote 41, Visa submission (25 February 2005).
market\textsuperscript{115} or interpretation of the exemption criteria unless there are relevant differences between the \textit{provisions} of the CA98 and of Community law entitling the OFT to do so (which there are not).\textsuperscript{116}

(vi) The OFT’s ability to depart from the \textit{Visa MIF} decision has become even more constrained as the result of the coming into force of the Modernisation Regulation.\textsuperscript{117}

123. Similarly, Amex has argued that the OFT is subject to an overriding obligation (by virtue of Article 10 of the EC Treaty, as expressed in the Modernisation Regulation and the jurisprudence of the European Court) not to enforce competition law (whether national or EC) in a manner that would contradict, impair or otherwise be inconsistent with existing or contemplated decisions of the Commission.\textsuperscript{118}

124. Amex argues, in particular, that:

(i) No relevant, significant, differences can be identified between the domestic and international aspects of the Visa MIF, or between the Visa MIF and MasterCard’s MIF.\textsuperscript{119}

(ii) In these circumstances, any OFT decision diverging from the position taken by the Commission, or failing to consider all the factors and cost elements considered by the Commission (either in the \textit{Visa MIF} decision or in the Commission’s ongoing investigation of MasterCard’s cross-border MIF) would necessarily and unavoidably be inconsistent with the Commission’s decisions.\textsuperscript{120}

(iii) While the \textit{Visa MIF} decision considered only the Visa cross-border MIF, there are clear implications for the MasterCard domestic MIF since many of the reasons for the Commission’s findings “\textit{relate to the MIF generally}” and should therefore be applied to the MMF UK domestic MIF.\textsuperscript{121}

125. These contentions of Visa and Amex are addressed by paragraphs 84-94 above. In summary, insofar as there is any duty such as that described at paragraph 122(i) above (which is open to doubt), there are insufficient similarities between the facts considered in the Commission’s \textit{Visa MIF} decision and the facts which are addressed by this Decision for the duty to apply in this case.\textsuperscript{122}

\textsuperscript{115} Paragraphs 54-59, Visa submission (16 May 2003).
\textsuperscript{116} Paragraph 2.1(11), Visa submission (11 January 2002) and paragraphs 5-11, Visa submission (16 May 2003).
\textsuperscript{117} Paragraph 3.2, Visa submission (25 February 2005).
\textsuperscript{118} See paragraph 12, Amex submission (4 February 2005).
\textsuperscript{119} Paragraph 19, Amex submission (4 February 2005).
\textsuperscript{120} Paragraph 22, Amex submission (4 February 2005).
\textsuperscript{121} Paragraph 26, Amex submission (4 February 2005).
\textsuperscript{122} Even where there are \textit{no} relevant factual distinctions between a case dealt with by the Commission decision and a case being considered by the OFT, it could be argued that, providing Article 16(2) of the Modernisation Regulation does not apply, the Commission decision is not determinative, at least as far as a national competition
126. As regards the ambit of the Visa MIF decision, it is simply not the case that any of the Commission’s findings apply “to MIFs generally”: see paragraph 9 of the Visa MIF decision. This is not to say that the OFT, in making this Decision, has not been faced, in some respects, with “corresponding questions” for the purpose of section 60 to those considered by the Commission in the Visa MIF decision but, as paragraphs 107-116 show (and as even Visa accepts), the OFT is not bound to follow the Commission’s approach to corresponding questions.

127. Visa has argued that the OFT’s approach to its obligations under Community law “jeopardises the fundamental principle of legal certainty” and is therefore wrong in law and inconsistent with broader European policy.123 Similarly, Amex has claimed that the OFT has taken “an overly narrow view of its obligations under EC law,” and that a decision of the OFT which diverged from that of the Commission in any material respect “would risk creating a patchwork of different, inconsistent decisions, making it impossible for credit card issuers to operate a unified payment system across the EU.”124

128. For reasons explained at paragraphs 84-95 above, in these circumstances an infringement decision by the OFT in relation to the (UK domestic) MMF MIF agreement does not undermine the effectiveness of the exemption granted by the Commission in the Visa MIF decision or otherwise prejudice the full and uniform application of Community law or the effects of measures taken or to be taken to implement Community law.

129. The OFT considers that Visa and Amex have overstated the practical difficulties which would result from such a divergence in this case, given the OFT’s understanding that there is divergence in the levels of domestic MIFs (and between domestic MIFs and cross-border MIFs) within the EU currently. But in any event, had the Commission considered that the OFT’s approach “jeopardised the fundamental principles of legal certainty” then it could have launched proceedings itself, with the effect, under Article 11(6) of the Modernisation Regulation, of relieving the OFT of competence to apply Article 81 to the MMF MIF agreement.125

authority such as the OFT is concerned, of whether a particular agreement restricts competition within the meaning of Article 81(1) or fulfils the conditions of Article 81(3) for the purposes of Article 3(2) of the Modernisation Regulation. It could be argued that the OFT has greater latitude in this respect than that which a national court was found to have by the Court of Appeal in the Crehan case (Bernard Crehan v Intentrepreneur Pub Company CPC [2004] EWCA Civ 637, currently under appeal). This follows, it would be said, from the fact that the OFT is itself an expert body and has the means to conduct its own detailed research and investigation (cf paragraph 76 of the court’s judgment in Crehan).

124 Paragraphs 18 and 21, Amex submission (4 February 2005).
125 The OFT has informed the Commission of this decision in accordance with Article 11(4) of the Modernisation Regulation (see paragraph 72 above). The Commission Notice on cooperation within the Network of Competition Authorities (OJ [27.4.2004] C101/03) states that the Commission may apply Article 11(6), in particular, where an
130. Visa has argued that the Commission’s use of language in its Visa MIF decision, such as “in particular”, “particularly” and “primarily”, when talking about the cross-border nature of the agreement it had to consider, clearly signals that its reasoning was, in these respects, applicable also in the domestic context.\(^{126}\) Similarly, Amex argued that the Commission’s finding that insurance (as an alternative for merchants to the payment guarantee against cardholder default) would be particularly expensive for cross-border payments indicated that the Commission considered such insurance would be equally necessary in the domestic context, albeit at lesser cost.

131. These contentions of Visa and Amex are addressed by paragraph 120(iii) above, in which the OFT responds to the similar argument made by MMF.

132. Visa maintained that, of the elements of the Visa MIF decision described at paragraph 80 above, the agreed reduction in MIF rates were subsidiary considerations and that “the essential criteria that led the Commission to grant exemption were the two criteria of objectivity [benchmarking of the MIF to costs independently assessed] and transparency [publication of MIF rates].” According to Visa, the OFT wrongly suggests that the reduction in MIF rates over the lifetime of the exemption was “the Commission’s key consideration in exempting the modified MIF…”.\(^{127}\)

133. As stated in the second bullet-point of paragraph 39 of the Visa MIF decision, “…reductions in the level of MIFs were part of a package of modifications proposed by Visa, together with elements on ‘objectivity’ and ‘transparency; these proposals must be considered as a package, not in isolation…” (emphasis added). It follows that, while the Commission was prepared to grant an exemption to the “package” of proposals before it, it can not safely be concluded, as Visa appears to be suggesting, that the Commission would have granted an exemption had any element of the package been absent.

134. Visa argues additionally that the OFT deviates “very significantly” from the Commission’s findings concerning the nature and function of a MIF in a four-party payment card system and, as a consequence, that it is difficult to accept that the OFT has had serious regard to the Commission’s analysis and findings.\(^{128}\)

135. Visa contrasts the OFT's description of the MMF MIF as, in broad terms, a price paid by acquirers which is intended to reflect payment transmission services\(^{129}\), with the Commission's finding that the MIF “has as its objective to increase the stability and efficiency of operation of [the Visa system]…and indirectly to strengthen competition between payment

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NCA envisages a decision which is obviously in conflict with consolidated case law (see paragraph 54(b)).

\(^{126}\) Paragraph 5.1, Visa submission (25 February 2005).

\(^{127}\) Paragraphs 4.1 to 4.6, Visa submission (25 February 2005).

\(^{128}\) Paragraphs 2.1 to 2.5 and 6.3(a), Visa submission (25 February 2005).

\(^{129}\) See paragraph 526 below.
systems by thus allowing four-party systems to compete more effectively with three-party systems.\textsuperscript{130}

136. There is no inconsistency between these two findings. The Commission’s finding relates to the object of the Visa MIF rather than describing its nature. At paragraph 67 of the Visa MIF decision the Commission found that, as a result of the MIF, “Issuing banks are required to charge acquiring banks a certain fixed fee and are therefore prevented from developing at wholesale level an individual pricing policy vis-à-vis acquiring banks in so far as they provide services to them.” It is therefore clear that the Commission too recognised the Visa MIF as a price paid for services provided at a wholesale level.

\textsuperscript{130} Paragraph 69, Visa MIF decision.
B THE RELEVANT MARKETS

SUMMARY

137. The OFT has taken as its starting point for the definition of the relevant market the supply of three distinct types of services related to the agreement:

(i) the supply of services provided between issuers and acquirers for the completion of purchases made using MasterCard branded consumer credit and charge cards ('Wholesale');

(ii) the supply of services provided by acquirers of MasterCard branded consumer credit and charge cards to merchants ('Acquiring'); and

(iii) the supply of services provided by issuers of MasterCard branded consumer credit and charge cards to cardholders ('Issuing').

138. The OFT has considered but does not accept the view that there is a single MasterCard product and that thus it is not possible to consider separate acquiring, issuing and wholesale services.

139. The OFT uses the hypothetical monopolist test framework to examine the relevant constraints on the pricing of these services and therefore the bounds of each of the relevant markets. To the extent that the pricing of the supply of wholesale services and the supply of acquiring services share constraints arising from the decisions of merchants and cardholders, these two areas are considered together. In these areas, it is important to note that the MMF MIF is collectively-set by the members of MMF, who comprise the main issuers of MasterCard credit and charge cards in the UK. The hypothetical monopolist test is therefore potentially vulnerable to the 'cellophane fallacy'.\textsuperscript{131}

140. The effect of a change in the level of the MMF MIF will depend on the actions (and interactions) of actors at various levels. The OFT therefore presents a systematic framework for analysing the effect of the existence of the MMF MIF on competition. This framework highlights the possible responses of acquirers, merchants and cardholders to a 5-10 per cent increase in the level of the MMF MIF.

Wholesale and Acquiring

141. In analysing the appropriate bounds of the wholesale and acquiring markets, the OFT first considers the response of acquirers to an increase in the level of the MMF MIF. The OFT finds that acquirers must offer a full range of card schemes (e.g. they cannot offer acquiring services for MasterCard but not for Visa, or vice versa) in order to win business from merchants. In addition, the MMF MIF forms a common cost to all acquirers and therefore can be passed on to merchants by an acquirer.

\textsuperscript{131} See paragraph 5.5, OFT403 Market Definition (December 2004).
without the acquirer being competitively disadvantaged. These two factors both mean that substitution by acquirers between different credit and charge card schemes would not take place in response to an increase in the level of the MMF MIF. Rather, such an increase would lead to an increase in the level of MSCs.

142. Next, the OFT considers the response of merchants to an increase in the level of MSCs. If a sufficient number of merchants were to exit the scheme, surcharge or otherwise discourage transactions in response to an increase in the level of MSCs, then this might reduce the number of card transactions made using MasterCard branded cards and therefore constrain the level of the MMF MIF. As a preliminary step in this stage of the analysis, the OFT examines cardholder reaction to merchant behaviour and how this influences merchant decisions. The OFT then looks at specific evidence relating to merchant exit from the scheme and surcharging:

(i) Evidence relating to merchant exit from the scheme in response to an increase in the level of the MMF MIF (and MSCs) is provided by data from the period following the reduction of the Visa domestic MIF in October 2003. The OFT also presents an econometric analysis of the relationship between the level of the MMF MIF/MSCs and the stock of merchants. Finally, the OFT draws on evidence from the MEPUK/ORC merchant survey. This evidence supports the view that insufficient merchants would exit the scheme to constrain a hypothetical monopolist’s 5-10 per cent increase in the level of the MMF MIF (or an MSC) above the competitive level.

(ii) With regard to surcharging, the OFT considers evidence from a survey conducted by FACTS International for the OFT, the MEPUK/ORC merchant survey, the Oxera cardholder discouragement survey (‘the Oxera discouragement survey’) and the DotEcon discouragement survey. Other submissions on this issue are also considered. As with exit, this evidence supports the view that insufficient surcharging would take place to constrain a hypothetical monopolist’s 5-10 per cent increase in the level of the MMF MIF (or an MSC) above the competitive level.

143. As well as analysing merchant exit and surcharging, the OFT examines the overall application of the small but significant non-transitory increase in price (‘SSNIP’) test by MMF and finds it to be flawed.

144. The analysis in this Section leads the OFT to conclude that neither merchant exit from the scheme nor surcharging exerts a sufficient constraint on an MSC or the MMF MIF to prevent a 5-10 per cent increase in price above the competitive level. On this basis, relevant wholesale and acquiring markets are defined as the supply of those services for transactions made with MasterCard branded credit and charge cards. However, the OFT notes that the inclusion of other branded credit, charge and debit cards in the relevant markets would not affect its conclusions on the appreciability of the restrictions arising from the MMF MIF agreement.
Issuing

145. In analysing the appropriate bounds of the issuing market, the OFT notes that cardholders do not tend to face charges from merchants for card use, so that cardholder fees and charges for card use are not directly affected by the level of the MMF MIF.

146. The OFT goes on to consider various aspects of the price of holding a credit and charge card. The Visa scheme is seen to be a sufficiently close substitute to MasterCard, from the perspective of cardholders, to be included in the relevant product market. MMF’s SSNIP test based on the hypothetical introduction of a transaction fee for cardholders is found to be flawed and the OFT conducts its own analysis of cardholder sensitivity by reference to increases in interest rates charged on outstanding balances. This analysis leads the OFT to conclude that the relevant issuing market is no wider than credit and charge cards.

Other factors

147. The OFT considers the possibility of supply-side substitution affecting its conclusions on market definition, but finds no evidence that it would sufficiently constrain the level of the MMF MIF or an MSC. Also, the findings of the Commission on market definition in its Visa MIF decision are not found to alter the OFT’s analysis.

148. With regard to geographic market definition, the OFT agrees that the relevant geographic market is the whole of the UK.

Conclusion

149. This analysis combines to lead the OFT to identify three relevant markets:

(i) the (wholesale) market for the provision of card transaction services between issuers and acquirers for purchases made by way of MasterCard branded consumer credit and charge cards in the UK;

(ii) the (acquiring) market for the provision of merchant acquiring services by acquirers to merchants for purchases made by way of MasterCard branded consumer credit and charge cards in the UK; and

(iii) the (issuing) market for the provision of branded consumer credit and charge card issuing services by issuers to cardholders in the UK.

INTRODUCTION TO MARKET DEFINITION

150. An agreement will infringe Article 81(1) and the Chapter I prohibition if it has as its object or effect an appreciable prevention, restriction or distortion of competition in the EC and UK respectively. Market definition
provides a frame of reference for making a full assessment of such matters as appreciability and the behaviour of the undertakings. The OFT’s objective in defining the relevant market in this case is to determine whether the MMF MIF agreement does appreciably restrict competition.

151. A relevant market should normally contain two dimensions: a product (or products) and a geographic area.

THE RELEVANT PRODUCT MARKETS

152. The relevant product market comprises all those products which are regarded as reasonably interchangeable by reason of the product’s characteristics, price or intended purpose. The process of defining a market starts with the product (or group of products) that is the focus of the investigation, the focal product(s).

The OFT’s position on the focal products

153. The object of market definition is to set out the market or markets on which the agreement may be expected to have an effect. Market definition is a key step in identifying the competitive constraints acting on a supplier. In the notification, MMF identified the MMF MIF as being a provision in the UK Domestic Rules which could raise particular concerns. The complaint of the BRC also focused on the MMF MIF and the multilateral interchange fees in other payment card schemes. Accordingly, the OFT’s starting point when defining the relevant product market is to consider the supply of services on which the MMF MIF agreement has effects.

154. The MMF MIF is the price that acquirers pay to issuers for the completion of purchases made using consumer credit and charge cards issued under the MasterCard brand. It is intended to reflect payment transmission services that are provided between them. The OFT notes, however, that credit and charge card transaction services are also provided by acquirers to issuers and that the MMF MIF is therefore a price that in principle reflects the flow of services in both directions and could be positive, negative or zero.

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132 See paragraphs 2.1-2.2, OFT403 Market Definition (December 2004).
133 See paragraph 2.15, OFT403 Market Definition (December 2004).
135 See paragraph 2.1, OFT403 Market Definition (December 2004).
136 See in particular the notification (1 March 2000) and the supplement to the notification (18 April 2000).
137 BRC submission (1 September 2000).
138 Note, however, that the OFT considers that issuers are currently reimbursed through the MMF MIF for services which are not payment transmission services (e.g. the interest-free period and some elements of the payment guarantee against cardholder default). See further paragraphs 681-694 below.
Since the price is set at a positive level, the MMF MIF is also a cost for acquirers proportionate to the monetary value of transactions processed. The MMF MIF represents an important part of acquirers’ costs and an increase in the MMF MIF, which the OFT notes is common to all acquirers, would be expected to be passed on in an increase in the MSCs which acquirers charge to merchants.¹³⁹ The MMF MIF can therefore be expected to have a direct effect on the prices charged by acquirers to merchants for acquiring MasterCard credit and charge card purchase transactions.

Finally, and again since the price is set at a positive level, the MMF MIF is a source of revenue to issuers proportionate to the monetary value of transactions initiated by the issuer’s cardholders using MasterCard branded credit and charge cards. Currently, cardholders do not face transaction charges from issuers for purchases but do face other charges imposed by the issuer for the use of their credit and charge cards, such as interest charges and annual fees.¹⁴⁰ An increase in the MMF MIF may lead (in part) to a reduction in cardholder charges or increased cardholder benefits. The MMF MIF agreement therefore has indirect effects on the supply of MasterCard credit and charge card services to cardholders by issuers.

In its assessment of the relevant markets, the OFT has considered the supply of three distinct types of services that are relevant to understanding the effects of the agreement on the MMF MIF:

(i) the supply of services provided between issuers and acquirers for the completion of purchases made using MasterCard branded consumer credit and charge cards ('Wholesale');

(ii) the supply of services provided by acquirers of MasterCard branded consumer credit and charge cards to merchants ('Acquiring'); and

(iii) the supply of services provided by issuers of MasterCard branded consumer credit and charge cards to cardholders ('Issuing').

The wholesale market

In coming to this conclusion on the focal products the OFT considered MMF’s representations in response to the SR14 Notice that no market can

¹³⁹ Between 2001 and 2003, the MIF on average accounted for 80 per cent of the level of the MSC (see footnote 13 above). The OFT also notes the evidence from EuroCommerce, cited by the Commission at paragraph 68 of the Visa MIF decision, that on average cross-border MIFs constitute 80 per cent of the MSC.

¹⁴⁰ Issuers do not currently levy charges on cardholders that are proportional to the transaction amount for transactions to which the domestic MIF applies. Indeed a number of card issuers offer their cardholders cash benefits, or benefits in kind, that are proportional to the value of transactions made on the card. For example, some issuers offer credit cards which accrue loyalty points redeemable for goods and services, while other issuers offer credit cards with a proportion of transaction value as 'cashback' (see Annex 7 (Loyalty schemes and affinity arrangements) of this Decision). A cardholder may face a charge for a transaction from a merchant that chooses to impose a surcharge on some or all credit card transactions.
be defined at the wholesale level, in relation to the supply of services between issuers and acquirers, because competition is not present at this level. In general, the OFT believes there is no requirement for there to be competition at a horizontal (or any other) level in order for a market to exist. The presence of competition affects the ability of a firm to set prices above cost, but its absence does not preclude a market from being defined.

159. In two recent cases, the Commission decision on the Reims II agreement\(^{141}\) and the UK Competition Commission's ("CC") report on termination charges for mobile telephony\(^{142}\) relevant markets have been defined at a 'wholesale' level when there has been a similar absence of competition. In these cases a consumer initiates a transaction either by posting a letter to an overseas destination or by dialling a phone number on a different mobile network. This initiation of the transaction places an obligation on the customer's supplier to trade with a second supplier, in order to terminate the transaction (by delivering the letter or connecting the call). In the case of Reims II, the obligation takes the form of a contractual obligation that is part of the agreement and which is similar to the honour all cards rule for MasterCard credit and charge cards.\(^{143}\) In mobile telephony, the obligation is the commercial obligation that subscribers expect to be able to make calls to all destinations. Under the rules of the MasterCard scheme, if a cardholder initiates a transaction using a MasterCard branded card, the honour all cards rule obliges the merchant to accept the card. In order for both the merchant and acquirer to obtain payment, the merchant's acquirer must route the transaction to the cardholder's issuer. In each of these three situations, once the transaction has been initiated, the supplier is unable to refuse the transaction and has no possibility to substitute an alternative supplier in order to complete the transaction.

160. In Reims II the Commission defined relevant markets for both outgoing and incoming cross-border mail. In the report on mobile telephony the CC concluded that there were separate relevant markets for the termination of calls on each of the mobile phone networks. The incoming cross-border mail market and market for termination of calls are markets for 'wholesale' services in the same way that the services provided by issuers to acquirers for the completion of card transactions may be classified as 'wholesale' services. The OFT believes that the approaches adopted in these cases demonstrate that there is no reason, in principle, why such a wholesale market may not be defined as a relevant market despite the constraints on competition imposed by the honour all cards rule.

161. The OFT recognises that in cases such as these, where substitution possibilities are absent at the wholesale level, it is necessary to consider the competitive constraints that arise at the downstream level. In the context of the MMF MIF agreement, the question for market definition is

whether substitution by merchants and cardholders represents such a strong constraint on the exercise of market power at the wholesale level that a hypothetical monopolist could not profitably raise the MMF MIF by a small but significant amount above the competitive level. A consideration of the constraints that apply in the form of substitution possibilities for merchants and cardholders is therefore an integral part of the definition of the relevant market at a wholesale level.

Two-sided demand

162. The OFT notes that ultimate demand for credit and charge card transactions is two-sided, from merchants on one side and from cardholders on the other side. The OFT has explicitly considered the competitive constraints that may result from merchant and cardholder behaviour. However, the OFT does not accept the view of the Parties that the presence of two-sided demand makes it necessary to consider a single relevant market based upon the card scheme as a whole. The relevant market(s) in cases of two-sided demand will depend upon the nature of the restriction in question and the economic conditions that apply in the market(s).

163. The OFT notes that previous cases dealing with situations of two-sided demand have led to the definition of separate relevant markets on one or both sides of the demand for a product. For example, in Aberdeen Journals the Competition Appeal Tribunal upheld the OFT’s market definition which focused on the relevant product market for advertising space in local newspapers. In Carlton/Granada, separate relevant product markets were defined for advertising and broadcasting activities. As a result, the OFT does not accept that the presence of two-sided demand requires that the market be defined in relation to the card scheme as a whole but takes the view instead that careful consideration must be given to each level of demand.

164. The OFT considers that, in addition to the wholesale services identified in paragraph 158-161, it is also appropriate to examine separate relevant markets on each of the two sides of demand: the acquiring and issuing markets. Accordingly, as the starting point for market definition, the OFT considers the supply of three groups of services: those supplied at the wholesale level between issuers and acquirers; those supplied by acquirers to merchants; and those supplied by issuers to cardholders.

The view of the Parties on the focal products

165. MMF argues that the starting point for the definition of the relevant market should be the scheme as a whole rather than any discrete part of it. This is because the scheme product is supplied to cardholders and merchants in strict complementarity, and cannot be provided to one side

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144 Aberdeen Journals Ltd v OFT [2003] CAT 11 at [301]-[308].
146 Paragraphs 1.9 and 3.3, Joint written representations on the SO.
without also being provided to the other. In addition, the MasterCard product is supplied “through cooperation between issuers and acquirers to merchants and cardholders only at the point of transaction” (emphasis in original).

166. Furthermore, a distinction must be made between cases of two-sided demand such as Aberdeen Journals and Carlton/Granada, which involve two distinct services being provided to two distinct customer groups, and the MasterCard product, which is a single product characterised by joint demand. Newspapers and broadcasting could in principle be provided without advertising. The MasterCard product must be provided simultaneously to both a cardholder and a merchant. As a result, it is not appropriate to isolate separate acquiring and issuing markets for the purposes of analysing the MMF MIF.

167. MMF argues that there is no wholesale market “because acquirers and issuers must cooperate at the ‘wholesale level’ in order to supply the MasterCard product, and there is therefore no sense in which competition could exist at that level” (emphasis in original). Cooperation between issuers and acquirers is a necessary pre-condition for the existence of the MasterCard product. This is because both an acquirer and an issuer must carry out their respective functions for the product to be supplied, and because the terms on which issuers and acquirers will jointly provide the MasterCard product must be settled in advance. Furthermore, the OFT inappropriately relies on the precedents of Reims II and the Competition Commission’s report on mobile termination charges since while cooperation is a necessary pre-condition for the existence of the MasterCard product, this is not the case for international postal services or mobile telephony.

168. Furthermore, the “MIF does not constitute a ‘price’ in any ordinary meaning of the word (ie as a signal which equalises supply and demand)”. Instead, the MMF MIF “is equivalent to an internal transfer within a joint venture” and “the default MIF is a balancing mechanism which reflects the difference between two ‘prices’: the ‘price’ paid by the acquirer for the issuer’s contribution to the system and the price paid by the issuer for the acquirer’s contribution to the system”.

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147 Paragraph 1.9, Joint written representations on the SO.
148 Paragraph 3.3, Joint written representations on the SO.
149 Paragraphs 3.19 and 3.21, Joint written representations on the SO.
150 Paragraph 3.21, Joint written representations on the SO.
151 Paragraph 3.14, Joint written representations on the SO.
152 Paragraph 3.15, Joint written representations on the SO.
153 Paragraph 3.17, Joint written representations on the SO.
154 Paragraph 1.11(a), Joint written representations on the SO.
155 Paragraph 3.2, Joint written representations on the SO.
156 Footnote 32 and paragraph 71 at Annex 2 (Report by Professor von Weizsäcker entitled “Economic Analysis of the MIF” dated 2 January 2004), Joint written representations on the SO.
The OFT’s findings on the Parties’ views

**There is not a single MasterCard product**

169. The OFT does not accept that the starting point for market definition should be the MasterCard scheme as a whole. Nor does the OFT believe that it is appropriate to view the diverse activities of issuers and acquirers as providing a single product. Merchants receive from acquirers services necessary to accept cards for use in their store. These may include a POS terminal and also ongoing authorisation facilities for transactions. Cardholders receive from issuers services such as the ability to make transactions in store and, for credit and charge cards, additional credit facilities together with any additional services, such as travel insurance, that issuers may choose to provide. These services are distinct. Merchants cannot substitute away from accepting cards for payment to paying using a card and similarly cardholders cannot substitute from paying by card to accepting cards for payment; they are distinct products supplied to merchants and cardholders. The MasterCard scheme can be seen as providing a platform on which wholesale, acquiring and issuing services can be provided to different sets of customers – but not a single product. MMF classifies all of these types of services as “cooperation enabling services” but this classification ignores material differences in both the services provided and the customers to whom they are provided. 157

170. MMF indicates that there are differences between newspapers and broadcasting, and credit card transactions.158 The OFT accepts that there are some differences between newspapers, broadcasting and advertising services, and the services provided by issuers and acquirers. However, it does not believe that these differences mean that it is inappropriate for the purposes of market definition to consider separate acquiring and issuing markets. In any case, while MMF notes that “Aberdeen Journals and Carlton/Granada involved two distinct services being provided to two distinct consumer groups” it has been shown above that this is also true of card issuing and acquiring where cardholders and merchants are distinct customer groups supplied with distinct services.

**Necessity for cooperation**

171. The OFT does not accept MMF’s view that the necessity for cooperation between issuer and acquirer in order to complete a transaction is different from the cooperation required for international postal services or mobile telephony. In both cases cooperation is a necessary prerequisite in order either to successfully deliver the letter to its international destination or to successfully connect the call. Therefore the OFT continues to believe that, as in Reims II and the Competition Commission report into mobile telephony, it is appropriate to consider a relevant market at the wholesale level.

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157 Footnote 37 and paragraph 72 at Annex 2, Joint written representations on the SO.
158 Paragraph 3.21, Joint written representations on the SO.
The MMF MIF is a price

172. The OFT considers it appropriate to view the MMF MIF as a price. An ordinary definition of a price is as a monetary value exchanged for a good, service or asset.\(^{159}\) In this context the MMF MIF sets the monetary value that an acquirer exchanges in order that the issuer provides the services necessary to complete the transaction and therefore the MMF MIF conforms to a straightforward definition of a price. The OFT accepts that as a price, which in principle reflects the flow of services in both directions, the MMF MIF may be set at a positive, zero or negative level.

173. Moreover, the MMF MIF does influence supply and demand decisions in the way expected of a price. It is clear that the demand from acquirers for the services of issuers is a derived demand which depends upon the decisions of merchants and cardholders. However, almost all demand in wholesale markets is derived demand. In the case of a four-party payment scheme once a transaction has been initiated, the acquirer must route the transaction to the card issuer irrespective of the level of the MMF MIF. But this is no different from other wholesale situations where a contract for inputs has already been agreed. In such cases, the effect of wholesale prices is felt in the prior stage of choosing the price at which to buy inputs and the subsequent decision on prices to charge consumers.

174. As noted in paragraph 412 below, the MMF MIF is a significant component of acquirers’ costs and will therefore affect the supply decisions of acquirers. An increase in the amount of the MMF MIF is likely to result in an increase in the amount of an MSC, which has a direct effect on a merchant’s decision on whether or not to accept MasterCard branded cards. In addition, because the MMF MIF is a source of revenue to issuers, it will influence the supply decisions of issuers. To the extent that the MMF MIF may affect the level of cardholder charges, it will also affect the demand from cardholders. Therefore, the MMF MIF has direct or indirect effects on supply and demand for wholesale, acquiring and issuing services.

175. MMF’s view that, over certain ranges, a lower MIF may in theory lead to a lower level of transactions does not imply that the MMF MIF cannot be a price. There are a number of theoretical explanations for a quantity sold being lower at lower levels of price including the existence of network effects. Other examples which may be sold less at lower prices include used cars and designer clothing, as well as services of network industries. Such an observation does not mean that the price mechanism is not at work in these cases: it simply means that the operation of the price mechanism may be complex.

176. An increase in the amount of the MMF MIF would be expected to lead to an increase in MSCs. This would lead to a movement up the downward sloping demand curve for services provided by acquirers to merchants and

\(^{159}\) The Routledge Dictionary of Economics, D Rutherford (1992) defines a price as “the amount of money, or something of value, requested, or offered, to obtain one unit of a good or service”. 

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some reduction in the number of merchants accepting cards. If it also leads to a reduction in cardholder charges, it would lead to a movement down the (downward sloping) cardholder demand curve for card usage as more consumers hold or use cards. Furthermore, there may be knock-on effects leading to shifts in the demand curves. For example, the reduction in the number of merchants may make the scheme appear of lower quality to cardholders, so the cardholder demand curve shifts. Conversely, a scheme with more cardholders may seem of higher quality to merchants and lead to a slight shift in the merchant demand curve. The net effect of these movements along (downward sloping) demand curves and of shifts in the demand curves can be that an increase in the MMF MIF may lead to an increase or decrease in the level of transactions. It cannot be concluded from this discussion that the MMF MIF is not a price. In fact, it shows the reverse - the MMF MIF precisely acts as a price leading to demand and supply responses.

177. MMF has called the MMF MIF a balancing mechanism. However in performing the role of a balancing mechanism the MMF MIF would also act as a price even according to MMF’s own preferred definition, i.e. a signal which equalises demand and supply. In order to act as a balancing mechanism the MMF MIF would have to have an effect, directly or indirectly, either on the demand decisions of merchants or cardholders or the supply decisions of acquirers or issuers, or an effect on some combination (possibly all) of these. Thus while the MMF MIF may be labelled a balancing mechanism, it is equally accurate to characterise it as a price, since it induces direct and indirect supply and demand responses.

178. Therefore having considered MMF’s representations on these points the OFT considers that it is appropriate to consider as the starting point for the definition of the relevant markets the three types of services identified in paragraph 157 above.

Framework for analysis of substitution

179. In Aberdeen Journals the Competition Appeal Tribunal judged it appropriate to look at evidence on the relevant product market “in the round”. In this case the OFT has considered a variety of forms of evidence on the substitutability of the different services provided by the issuers and acquirers of the MasterCard scheme and has considered this evidence in the round. However, as a useful framework for organising the evidence on the definition of the relevant product markets the OFT has made use of the SSNIP test.

180. Taking each of the services described in paragraph 157 in turn, the OFT has considered whether the relevant product markets should be widened from the initial sets of services on account of demand and supply-side substitutability. Conceptually, the underlying question that the OFT has asked is whether a hypothetical monopolist controlling the supply of the services in the candidate relevant market could profitably raise price by a

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161 Or equivalently a ‘hypothetical cartel’ of suppliers.
small but significant amount above the competitive price, using a 5-10 per cent price rise as a rough guide.\textsuperscript{162} If enough business would switch to substitutes to prevent a hypothetical monopolist from profitably exercising market power by maintaining prices above the competitive level, the candidate relevant market should be widened. The same test should be applied to the widened market until the point at which the hypothetical monopolist could profitably exercise market power and that is where a relevant market is defined. This conceptual framework is explained in further detail in the OFT’s \textit{Market Definition} guideline.\textsuperscript{163}

181. At paragraphs 193-199 the OFT has considered the supply of MasterCard branded credit and charge card services between issuers and acquirers. The key question is whether there are sufficient competitive constraints to prevent the MMF MIF from being raised above its competitive level by a small but significant amount. Consideration of this question requires an analysis of the response of acquirers, merchants and cardholders to such an increase and the substitution possibilities at each level. This is considered further at paragraphs 201-205.

182. At paragraphs 207-300 the OFT has also considered the consequent supply of merchant acquisition services provided by acquirers to merchants for MasterCard branded credit and charge card transactions for which an MSC is payable. The competitive constraints on MSCs are determined by the substitution possibilities for acquirers’ merchant customers and this in turn is influenced by the choices of cardholders. To the extent that the supply of wholesale services and the supply of merchant services share constraints arising from the behaviour of merchants and cardholders, these two markets are considered together.

183. Finally, at paragraphs 304-327 the OFT has considered those services provided by issuers to cardholders. The OFT has considered whether a hypothetical monopolist issuer would be able to raise cardholder charges by a small but significant amount above the competitive level. Consideration of this question involves an analysis of the competitive constraints on the charges levied on cardholders by issuers. These constraints are substantially different from those in the wholesale and merchant markets. Therefore, the evidence on the cardholder market is considered separately, after the consideration of the wholesale and acquiring markets.

184. In considering the wholesale and acquiring markets, it is important to observe that the MMF MIF is set by collective agreement between the members of MMF, who comprise the main issuers of MasterCard credit and charge cards in the UK. It has long been recognised that the hypothetical monopolist test is potentially vulnerable to the ‘cellophane fallacy’.\textsuperscript{164} An actual monopolist (or cartel) has the incentive to raise prices

\textsuperscript{162} When applying this framework, it is important to recognise that existing prices may actually be set above the competitive price. See further paragraphs 5.4-5.6, OFT403 \textit{Market Definition} (December 2004). See also paragraph 184 below.

\textsuperscript{163} Paragraphs 2.5-2.13, OFT403 \textit{Market Definition} (December 2004).

\textsuperscript{164} Paragraphs 5.4-5.6, OFT403 \textit{Market Definition} (December 2004).
to the level where substantial substitution will occur in the event of a further price increase. In cases where a single monopolist exists, or there exists a group of firms who set prices collectively, if substitution possibilities are examined relative to the current price level, it may lead to the incorrect conclusion that substitutes constrain the ability of the monopolist to exercise market power. As a result, the relevant market may be defined too widely. In this case, an actual agreement between members of MMF on the level of MIF already exists and, as such, the agreement may already have raised the MMF MIF above the competitive level to a point where other payment methods become substitutable for MasterCard credit and charge cards. Consequently, examining the effect of a small but significant increase in price above the current level in the relevant market may lead to an erroneously wide definition of the relevant market. However, any error in this regard would have the effect of understating the market position of the Parties.

The Parties’ views on the framework for analysis of substitution

185. MMF has argued that the starting point for the definition of the relevant market is the MasterCard product and that the relevant market includes all payment methods. It provides evidence to show that other payment methods are substitutable for the MasterCard product from the perspective of cardholders and of merchants and that the MMF MIF is subject to competitive constraints.165

186. Furthermore MMF argues that, because of the joint demand feature of the MasterCard product, any SSNIP test must be applied to the two demand sides. Since only the sum of the prices on each of the two sides of demand is a cost signal, any SSNIP test must be applied to the sum of prices for the whole scheme.166

187. The OFT cannot rely on the cellophane fallacy to dismiss evidence on substitution. First, the MasterCard scheme is subject to competitive constraints from other payment methods. Secondly, the OFT has not produced evidence that the MMF MIF is too high and there is no indication that the MMF MIF is too high. Thirdly, the theoretical analysis of payment schemes demonstrates that in a fully competitive payment systems market a MIF may be set that implies a level of merchant service charges that is high relative to the incremental cost of acquirers.167

OFT’s response to the Parties’ views on the framework for analysis of substitution

188. As stated in paragraph 169 above, the OFT does not accept that the relevant starting point is the MasterCard scheme as a whole. The OFT has considered the evidence submitted by the Parties in detail, and this

165 Paragraph 3.26, Joint written representations on the SO.
166 Footnote 45, Joint written representations on the SO.
167 Paragraph 40 at Annex 1 (Economic evidence in support of market definition), Joint written representations on the SO.
evidence is discussed where relevant below, but is not persuaded that there is a single relevant market for all payment methods.

189. The OFT does not accept that the hypothetical monopolist test must be applied to the sum of merchant and cardholder prices. The arguments made on this point rely on the assumption that there is a single MasterCard product. As has been demonstrated above, this is not the case.

190. Furthermore the levels of the MMF MIF, MSCs and cardholder charges all influence, directly and indirectly, the demand for and supply of wholesale, acquiring and issuing services. The MMF MIF sets a minimum cost for acquirers, and therefore influences the level of MSCs. An MSC in turn influences merchant demand in the form of the decision whether or not to accept MasterCard branded cards. The level of the MMF MIF can influence the terms on which issuers offer MasterCard cards to cardholders, which in turn influence the decisions of consumers to hold and use cards. While care must be taken to recognise the potential that merchant demand is influenced by cardholder decisions this does not mean that careful analysis of the effects of price on the supply and demand for each of these services is not relevant to the analysis of competitive constraints.

191. The hypothetical monopolist test provides a useful framework for considering issues of substitution. However, there are limits to the applicability of the hypothetical monopolist analysis. One of the problems in applying the hypothetical monopolist test is the cellophane fallacy.

192. In this case, market power can manifest itself in the following way. Where a card scheme has cardholders who have only one card or a preference for using a particular card, market power exists because a merchant must deal with the scheme in order to gain access to those customers. The price charged will be determined by the willingness to pay of the merchant and not the costs of supplying the merchant. Unless there is a form of competition such that there is a tendency for the price to merchants to be brought into line with the cost of supplying merchants, the cellophane fallacy will apply. Given this context, there is a very real risk that the current level of the MMF MIF has been set according to merchants’ willingness to pay and thus the cellophane fallacy is relevant.

**The hypothetical monopolist test: the wholesale market**

193. The OFT has considered the likely reactions of acquirers, merchants and cardholders to a 5-10 per cent increase in the level of the MMF MIF above the competitive level. Figure 2 illustrates the potential consequences of a MIF increase, tracking the responses of acquirers, merchants and cardholders in turn. Responses leading to the right of the dashed line take acquirers, merchants and cardholders out of the credit card scheme, i.e. the acquirer leaves the scheme, the merchant stops accepting the scheme’s cards or the cardholder uses an alternative payment method. Critically, it is the value of those transactions that the card scheme may lose as a result of an increase in a MIF that will determine whether there are sufficient competitive constraints on the MIF to prevent such a
hypothetical monopolist from profitably raising it above the competitive level.

**Figure 2:** The potential effects of an increase in a MIF

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194. Following an increase in a MIF, acquirers are likely to pass on the increase to merchants in the form of an increased MSC. Alternatively, acquirers may choose to exit the MasterCard scheme and/or acquire for another card scheme.

195. If an acquirer exits the scheme, its merchants would have also to decide whether to stop accepting the scheme’s cards or to switch to an acquirer which does accept the scheme’s cards. If the acquirer instead increases the applicable MSC then the merchant may stop accepting cards, may increase prices in general to cover the increase in costs or may choose to surcharge the scheme cards (or increase the level of any existing surcharge) or otherwise discourage the use of the scheme’s cards.¹⁶⁸

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¹⁶⁸ Or simply absorb the increased cost and leave its retail prices unchanged.
196. It is instructive when considering the options for merchants to present an illustration of the effect on an average transaction of a ten per cent increase in the MMF MIF above its competitive level. For example, consider a purchase made with a MasterCard branded credit or charge card for a basket of goods priced at £60.\textsuperscript{169} If the competitive MMF MIF were equal to one per cent of the retail price, a ten per cent increase in the MMF MIF would lead to a MIF of 1.1 per cent;\textsuperscript{170} and if the increase were passed on in full as an increase in MSCs, this would increase MSCs by 0.1 percentage point. The effect is that an MSC payable on the £60 MasterCard transaction would rise by six pence. If MasterCard transactions accounted for 15 per cent of all transactions for the merchant,\textsuperscript{171} and the merchant responded by increasing retail prices for transactions by all payment methods to cover the increase in an MSC of six pence, the retail price of the basket of goods would need to increase by just under one penny.

197. If a merchant stops accepting cards, the cardholder can choose an alternative payment method or can choose to visit an alternative retailer that does accept cards. If a merchant surcharges, the cardholder can continue to use the card and pay the surcharge, use an alternative payment method, or go to another merchant. If a merchant increases retail prices or absorbs the cost, then the cardholder can continue to use his or her credit card. It is possible that the cardholder could switch to another merchant that does or does not accept cards in this latter case, but there is little or no incentive for the cardholder to do so.

198. It is instructive to consider further the example given in paragraph 196. For a merchant to consider stopping accepting scheme cards in response to the increase in MIF, it must weigh up the costs and benefits. For the average transaction of £60, the amount saved if the customer uses an alternative payment method could be as little as six pence.\textsuperscript{172} If the merchant has a retail margin of 33 per cent, it would lose £20 for a £60 transaction foregone because the customer chooses an alternative merchant as a result of the first merchant choosing not to accept

\textsuperscript{169} In 2004 the average value of a purchase transaction in the UK made using MasterCard branded credit and charge cards was £60.73. This can be calculated from the details in Tables 4 and 5 above.

\textsuperscript{170} The average MMF MIF is slightly above [0.90-1.10] per cent, but as noted in paragraph 184 above this may have already have been set at a level above the competitive level. The one per cent figure is assumed for simplicity, and should not be taken to imply that the OFT believes the competitive level to be one per cent.

\textsuperscript{171} In 2004, MasterCard credit and charge card transactions accounted for 15.7 per cent of the monetary value of credit, charge and debit card purchase transactions in the UK: see Table 7 above. Since this ignores other payment methods such as cash or cheque adopting the figure of 15 per cent implies the calculated figure of slightly less than a penny may be an overestimate.

\textsuperscript{172} Six pence would be saved if a customer used an alternative scheme’s credit or charge card for which the same assumed competitive level of the MIF of 1 per cent were set. If customers switched to alternative payment methods the amount saved would depend on the relative costs of the different payment methods. All payment methods have some cost to the merchant.
MasterCard cards.\footnote{Ernst and Young predicted that for the year 2002 the average retail margin in the UK would be 33.6 per cent, \textit{UK Retail}, Ernst and Young, February 2002. Even if the retail margin for a particular retailer were much lower, for example 10 per cent, then a retailer with such a margin may not find it worthwhile to stop accepting cards in the face of the hypothetical increase in MIF even if just over one in a hundred former MasterCard customers were to use a different merchant as a result.} Therefore, it could be unprofitable to stop accepting MasterCard cards even if the merchant lost as few as one in three hundred customers, who previously used their MasterCard branded card for transactions, as a result.

Each of the steps outlined above is analysed in more detail below. The OFT considers that the most likely steps following a small but significant increase in the MMF MIF above the competitive level would be that acquirers would continue to acquire for the scheme and would pass on the increased MIF in increased MSCs; that merchants would recover the additional cost of MSCs by raising retail prices; and that cardholders, who would not face the costs of increased MSCs directly or a decision as to whether to switch to a different merchant who continues to accept their credit and charge cards, would continue to use their cards.\footnote{The Commission made a similar finding (see paragraphs 48, 80 and footnote 39, \textit{Visa MIF decision}).} In this situation, the reaction of merchants and their customers would not constrain the hypothetical monopolist’s ability to raise the MMF MIF above the competitive level, and the relevant product market should not be widened.

The hypothetical monopolist test: the acquiring market

As explained in paragraph 412, the MMF MIF is a common component of the costs to acquirers of acquiring MasterCard credit and charge card transactions. In examining the effects of the MMF MIF, it is relevant to consider the boundaries of the relevant markets on which it impacts. In assessing the relevant market for services provided by acquirers to merchants, it is necessary to consider whether it would be profitable for a hypothetical monopolist acquirer to increase MSCs above the competitive level by a small but significant amount. Consideration of this question requires examination of the response of merchants and cardholders to such an increase in MSCs. These steps are set out in Figure 3. It is clear that Figure 3 includes the same steps as Figure 2, except for the initial response of acquirers to the increase in a MIF. As a result, there are significant overlaps in the analysis of the reactions of merchants and cardholders in considering both the wholesale and the acquiring markets. The relevant steps have been described in paragraphs 193-198 above.
The response of acquirers to an increase in the MMF MIF

201. In the UK there are presently twelve acquirers for the MasterCard scheme. In addition to acquiring for MasterCard, nearly all of these acquirers also act as acquirers in the UK for the other major UK four-party payment card schemes, Visa Credit, Visa Debit and Maestro/Switch. Almost all merchants choose to deal with only one acquirer for the four-party card schemes that they accept, and all merchants in the UK have the same acquirer for the MasterCard and Visa credit and charge card schemes. It is apparent from responses received from acquirers in the UK to OFT information requests that all merchants that accept Visa credit and charge cards also accept MasterCard branded cards and vice versa.

202. For an acquirer to be in a position to compete effectively for the custom of merchants, it must acquire for all four-party card schemes. An acquirer does not choose to acquire either for one card scheme or another. Instead, acquirers offer the full range of cards to merchants. As a result the OFT does not believe that any acquirer would choose to exit the MasterCard credit card scheme following an increase in the MMF MIF of 5-10 per cent above the competitive level. To do so would risk losing a large proportion of its business.

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175 See paragraph 26 above.
176 Citibank International plc does not acquire transactions made using Maestro/Switch debit cards: e-mail from Citigroup to the OFT (1 July 2005). [REDACTED].
177 Evidence provided to the OFT in July and August 2004 by the major acquirers in response to the OFT information request under section 26 of the CA98 indicates that at least 95 per cent, and maybe as many as 99 per cent of merchants use the same acquirer for acceptance of the major four-party credit and debit cards.
of the acquirer’s merchant base, who would wish to continue accepting MasterCard cards in addition to those of the other payment card schemes, and would severely limit the acquirer’s ability to compete for new business.

203. The MMF MIF is an input cost for acquirers and forms a common price floor for the MSCs charged to merchants. The likely reaction of merchants described above means that acquirers would not be constrained in passing on to their customers the full cost of a MIF increase above the competitive level. The OFT therefore believes that acquirers would not exit the scheme but would instead pass on the increase in the MMF MIF, in full or in part, by increasing MSCs charged to their merchant customers.

The pass through of a MIF increase to MSCs

204. When considering the effect of an increase in the amount of a MIF on the MSCs charged to merchants, it is important to note that many merchants are charged a ‘blended’ MSC. An MSC is blended when the level of that MSC is common to Visa and MasterCard credit and charge cards, even though there may be some difference in the MIFs paid by acquirers for transactions made using different schemes’ cards. For the period from 1 March 2000 until October 2002, the MIFs applied by the Visa and MasterCard schemes were almost identical. Up until this point, the blending of rates that commonly occurred may thus have been a consequence of the common level of the MIF that acquirers faced for each scheme. However, since October 2002 and particularly from October 2003 until October 2004, certain key MIF rates have differed between the schemes, but a significant majority of merchants are still charged a blended MSC.

205. The effect on MSCs of an increase in the MMF MIF above the competitive level is likely to be lower when an MSC is blended than when it is unblended, since the increase will be averaged across all Visa and MasterCard credit and charge card transactions. Since MasterCard accounts for just over a third of the combined Visa and MasterCard credit and charge card transactions, this implies that the average cost to an acquirer will increase by just over a third of the percentage increase in the MMF MIF. Therefore, where the MSC is blended, an increase in the MMF MIF will be passed on in a higher MSC amounting to only a third of the

178 See paragraph 235 and Table 10 below for details of the Visa MIF and MMF MIF levels over time.
179 See paragraph 235-238 below. In paragraph 3.24, Joint written representations on the SO, MMF has stated that “for three of five main UK acquirers, a significant majority of MasterCard transactions and MasterCard MSC revenues are now accounted for by unblended rates. Indeed, in the UK, well over half of all MasterCard transactions and MasterCard MSC revenues are now accounted for by unblended rates.” These observations are not inconsistent. If large merchants account for a significant proportion of transactions and these large merchants do not face blended MSCs the majority of merchants could still face blended MSCs.
180 38 per cent of the combined value of MasterCard and Visa credit and charge card purchase transactions in the UK was accounted for by MasterCard in 2004. This can be calculated from the details in Table 5 above.
increase in the MMF MIF - although the increase would apply to both MasterCard and Visa transactions. A prospective 10 per cent increase in the MMF MIF from 1 per cent to 1.1 per cent may lead to an increase in the level of a blended MSC of 0.038 percentage points, for example from 1.25 per cent to 1.288 per cent.

206. Even if MSC levels were not widely blended, a small but significant increase in the MMF MIF of 5-10 per cent would not usually imply a corresponding increase in MSCs of the same amount. The OFT understands that the average proportion of MSCs accounted for by the MMF MIF is 80 per cent. However, the actual proportion will vary across merchants depending, in particular, on their ability to negotiate down the level of MSCs. For those merchants that negotiate an MSC near the level of the MMF MIF (which may be the larger merchants), the MMF MIF may constitute more than 90 per cent of their MSCs.\footnote{Annex 1 (DotEcon Merchant Study), Joint written representations on the SR14, includes information showing that merchants reported credit card MSC levels between 0-9/ per cent. In May 2004, the average MMF MIF was /0.90-1.10/ per cent (Letter from Lovells to the OFT (17 May 2004)). For those acquirers supplying the merchants reporting the lowest MSC levels, MIF costs are therefore likely to represent in excess of 90 per cent of MSC revenue from those merchants.} For those merchants that are unable to negotiate a lower MSC (which may be the smaller merchants), the MMF MIF may represent less than one half of the cost of their MSCs. A 5-10 per cent increase in the MMF MIF may lead to close to a 5-10 per cent increases in the applicable MSC for the first group of merchants, but the implied increase in MSCs may be around 2-4 per cent for the second group of merchants.

The response of merchants to an increase in MSCs

207. In considering both the wholesale and the acquiring markets, it is necessary to consider the response of merchants to an increase in the level of MSCs. The OFT has noted in paragraph 205 that a 5-10 per cent increase in the MMF MIF is likely in many cases to translate into a proportionately smaller increase in MSCs faced by merchants. However, the OFT does not believe, in this case, and based upon the consideration of the evidence presented below, that whether a 5-10 per cent increase in MSCs or a proportionately smaller increase in MSCs is considered materially influences the conclusions on substitution. In either case, the evidence suggests that substitution would be insufficient to constrain the increases in the MMF MIF or MSCs. Therefore, conservatively, the evidence is considered in relation to a 5-10 per cent increase in MSCs.

208. The OFT has considered evidence from which it is able to determine whether merchants would, in the face of a 5-10 per cent rise in the level of MSCs, switch away/exit from accepting MasterCard branded credit and charge cards to rely only on alternative payment methods (such as alternative credit and charge card brands, store cards, debit cards, cash or cheques). The OFT has also considered whether, in these circumstances, merchants would be likely to surcharge or otherwise discourage their MasterCard credit and charge card customers. Evidence of exiting or
surcharging could result in the relevant product market being widened to include other forms of payment methods.

209. As noted above at paragraphs 196-197, whilst any increase in an MSC is payable in the first instance by merchants, the reaction of merchants will be affected by the conduct of their cardholder customers. The OFT has therefore also considered the potential effects of an increase in MSCs on cardholder choices.

210. In forming its judgement on the reaction of merchants to an increase in MSCs, the OFT has considered the following detailed evidence:

(i) the characteristics of alternative payment methods (see paragraphs 216-224);

(ii) data provided by MMF on merchant pricing and acceptance following the reduction in the Visa MIF in October 2003 (see paragraphs 235-241);

(iii) data provided by MMF covering the period 1996 to 2001 regarding the level of the MMF MIF and the number of merchants accepting MasterCard credit and charge cards (see paragraphs 243-251);

(iv) the MEPUK/ORC merchant survey, designed to assess merchants’ reactions to an increase in MSCs (see paragraphs 252-260 and 277-278);\(^{182}\)

(v) the merchant survey commissioned by the OFT and conducted by FACTS International Limited to examine the extent and determinants of merchant surcharging (see paragraphs 265-272);

(vi) the Oxera discouragement survey designed to assess the cardholders experience of discouragement (see paragraphs 273-274);

(vii) the DotEcon discouragement survey designed to assess the factors affecting consumer’s choice of merchant and payment method in the context of discouragement (see paragraphs 275-276); and

(viii) The MMF Merchant Study and the application to a SSNIP analysis for merchants (see paragraphs 292-300).\(^{183}\)

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\(^{182}\) MEPUK/ORC merchant survey (October 2001).

\(^{183}\) Paragraphs 3.2.5 – 3.2.18 at Annex 1 and section 5.2 at Annex 3 (Oxera: *Theories of interchange, social optimum and competition between payment systems*), Joint written representations on the SR14.
Factors affecting merchants’ reactions: the substitutability of other payment instruments from the cardholders’ perspective at the point of sale

211. In making the decision whether to exit from the MasterCard credit and charge card schemes, the merchant will assess customers’ likely response to such withdrawal. The customer has two alternatives: first to purchase with the merchant and use an alternative payment method; second to purchase with an alternative merchant that accepts MasterCard credit and charge cards. It is the proportion of consumer purchases for which alternative payment mechanisms are not regarded as substitutable with branded credit and charge cards that determine whether it would be profitable for a merchant to stop accepting the scheme’s cards.184

212. Cardholders who do not regard alternative payment mechanisms as substitutable will seek out an alternative merchant where available, and some cardholders may value certain of the characteristics of MasterCard branded credit and charge cards sufficiently highly as compared with other payment instruments that merchants would lose business to their competitors if they unilaterally refused to accept payment using them. In this regard, the Commission found that once a merchant already accepts Visa cards, when faced with an increase in MSC, recovering this cost increase through a very small price increase for all goods sold will normally lead to a smaller fall in turnover than ceasing to accept Visa cards.185

213. Paragraph 196 above illustrates that a 10 per cent increase in the MMF MIF may be recovered by a merchant by raising the price of a basket of goods priced at £60 by as little as a penny. In addition, a merchant could find it profitable to continue accepting MasterCard cards while absorbing the extra cost of an increase in MSCs. This would be the case even if a merchant were to lose only a very small proportion of its customers, perhaps as few as one in three hundred, if it were to cease to accept MasterCard cards. Furthermore, it is important to recall when considering the merchant’s decision that all merchants are likely to face a similar increase in MSCs as a result of the increase in MIF.

214. In making the decision whether to surcharge consumers using branded cards the merchant will ordinarily assess the customer’s response to such surcharging. The customer has three alternatives when faced with a merchant that levies a surcharge. First, to purchase with the merchant using an alternative payment mechanism; second, to purchase with the merchant using a MasterCard card and pay the surcharge; and third to

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184 In paragraph 3.32, Joint written representations on the SO, MMF has criticised the OFT for failing to focus on the marginal consumer. However, in this case it is not the marginal consumer (in the sense of the consumer who is indifferent between alternative payment methods) who determines the merchant’s decision. It is the proportion of consumers who value the credit card product highly (in economic terms, the ‘infra-marginal’ consumer) and who would not substitute to an alternative payment method but would instead switch to an alternative merchant, which determines whether or not the merchant continues to accept the scheme’s cards.

185 See paragraphs 48, 80 and footnote 39, Visa MIF decision.
purchase with an alternative merchant that does not surcharge MasterCard branded cards. The merchant will compare the value of purchases lost to alternative merchants via the third group of consumers with an assessment of the costs of, and revenue from, surcharging credit and charge card cardholders in order to determine whether it would be profitable to surcharge.

The MMF MIF and cardholder incentives

215. Before considering the alternative payment methods in turn, it is helpful to note that an increase in the MMF MIF, which leads to increased per transaction revenue for issuers, may be expected, through competition between issuers, to lead to a fall in cardholder charges or an increase in cardholder benefits. This potential fall in cardholder charges could in turn lead to an increase in the number of MasterCard cardholders and/or increase the desirability for a cardholder of using a MasterCard credit or charge card relative to other payment mechanisms. Insofar as this happens, the increase in the MMF MIF could strengthen the cardholders desire to pay using the card, and hence heighten the risk to the merchant of losing the cardholder’s custom. The cardholder’s decision as to whether to continue to use his or her MasterCard credit or charge card is therefore influenced not only by the merchant’s response to an increase in MSCs but also by any benefits that the cardholder receives indirectly from the issuer as a result.

Alternative payment methods

216. The OFT’s concern in this section is to establish which consumers in which circumstances when faced with a store that did not accept MasterCard cards, or surcharged those cards, would not purchase in the store.

217. As a first step, the OFT has considered the likelihood of cardholders switching to other brands of credit and charge card, particularly Visa. While there are differences between issuers on the precise terms offered to credit and charge card cardholders, for a cardholder there is almost no difference in the functionality of the credit or charge card based upon whether it is a MasterCard or a Visa branded card. Some issuers issue only Visa or only MasterCard branded cards while some issue both. A number of issuers offer prospective cardholders a choice of a Visa branded or a MasterCard branded card on identical conditions. However, virtually all merchants in the UK that accept MasterCard branded credit cards also accept Visa branded credit cards, and vice versa. The OFT considers that this is a key fact in considering merchant incentives. Therefore the only salient reason for choosing one brand over another would appear to be the variance in merchant acceptance internationally. However, most MasterCard cardholders do not own both a MasterCard and a Visa credit card.

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186 For example, Tesco Personal Finance, Lloyds TSB and MBNA offer cardholders the choice of a Visa or MasterCard branded card on the same terms and conditions for some of their credit card products.

187 See footnote 177 above.
branded credit card and therefore would be unable to substitute if a merchant declined to accept MasterCard cards. By way of illustration, a survey commissioned by the OFT estimated that 63 per cent of credit card cardholders possess only one credit card, and that 73 per cent of card cardholders have only one card in active use. Some cardholders are unlikely to apply for a new Visa branded card merely if a limited number of merchants choosing not to accept MasterCard branded cards. Instead they may simply opt to use an alternative merchant with their existing MasterCard branded card.

218. **Debit cards** possess the same physical characteristics as credit and charge cards and can be used for low or high value transactions, depending upon the availability of funds in the cardholder’s account. However, the OFT considers that the deferred payment facility, which is particular to credit and charge cards, is important to consumers such that many consumers may have a strong preference for using their credit card over a debit card.

219. Transactors do not need to rely on the extended credit facility of credit cards. However, credit (and charge) cards offer them unique and valued characteristics as a payment method. For transactors, using a credit or charge card is more advantageous than using a debit card, since it allows all transactions to be financed out of borrowed funds while the transactor’s savings may be left in an interest-bearing account. The interest-free period available on most credit and charge cards allows interest to be earned, which would not be earned if transactions had to be paid out of the cardholder’s bank account immediately.

220. While debit cards do offer some of the functionality of credit and charge cards, the OFT believes that there is a significant proportion of credit card cardholders who value the additional functionality of credit cards sufficiently not to regard them as substitutable. As a result, merchants would expect to lose the custom of those credit and charge card cardholders to competitors if the merchant stopped accepting credit and charge cards or surcharged.

221. From a consumer’s point of view, cash can be inconvenient, unwise to carry in large amounts and unsuitable for expensive purchases, which may make it less attractive to use than credit, charge or debit cards for large transactions. Thus while for small transactions many credit and charge cardholders may be willing to use cash if unable to use their card or unwilling to pay a surcharge, for large transactions the proportion who are willing or able to switch to cash is likely to be lower.

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188 Chart 4.13, OFT709 Credit Card Survey (March 2004).
189 See paragraph 13 above.
190 Alternatively transactors may avoid incurring some debt, such as an increase in overdraft, as a result of the extended credit facility and may therefore save on interest payments.
191 This is also the view taken by the Commission in Case Comp/29.373 Visa International OJ [10.11.2001] L293/24, paragraph 38 and the Visa MIF decision, paragraph 49.
Whilst the OFT considers that credit and charge cards may often act as good substitutes for cheques, the reverse will be true to a far lesser extent. In an environment where guaranteed payment must be received before releasing or supplying goods or services, low cheque card limits restrict the use by consumers of cheques as an alternative to credit and charge cards. Merchants who are willing to accept cheques above this limit lose their protection from fraud or the customer’s inability to pay. Therefore, particularly for high value purchases, some cardholders may be unable or unwilling to substitute to cheques if the merchant does not accept MasterCard branded cards.

Store cards may be substitutable for some customers in some circumstances. However, relatively few merchants offer a store card. In addition, MasterCard cards have wide acceptance at merchants, therefore the cardholder needs to possess only one card. Store cards are specifically accepted at the store or store group that issues the card and to effectively substitute if a merchant does not accept MasterCard branded cards a cardholder must be willing to hold possibly multiple store cards.

Finally, credit card users, but not charge card users, benefit from the issuer being joint and severally liable with the supplier by virtue of the Consumer Credit Act 1974. There is no equivalent protection for consumers paying by cash, cheques or debit cards.

**Views of the Parties on alternative payment methods**

MMF has argued that the above consideration of the alternative payment methods is insufficient to exclude these payment methods from the relevant market. It has argued that it is not necessary for MasterCard credit cards to be perfectly substitutable with other payment methods. What is relevant is to consider the marginal consumers who would switch payment methods in sufficient numbers to constrain an increase in price.

MMF has presented survey evidence on the response of cardholders to the non-acceptance of cards or discouragement of cards by merchants.

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192 Whilst credit and charge cards will be subject to overall spending limits, these will be significantly higher than the maximum spending limit on cheques for each transaction.
193 The BRC has submitted to the OFT that the maintenance of what it considers to be “artificially low” cheque card limits may be a deliberate policy by the banks to move customers from cheques to their payment cards (see BRC submission (1 September 2000)).
194 MMF’s observation that the average value of a cheque transaction is significantly higher than the average value of a card transaction does not contradict this conclusion since many cheques will be paid in environments other than a POS transaction where a guaranteed payment is unnecessary (paragraph 3.39, Joint written representations on the SO).
195 See Executive Summary, Mintel, Store Cards, Finance Intelligence (October 2004).
196 Section 75, Consumer Credit Act 1974.
197 Paragraph 3.30, Joint written representations on the SO.
198 Paragraph 3.32, Joint written representations on the SO.
199 Annex 5, Joint written representations on the SO.
From this survey data it concludes “that cardholders find paying by a different method at the same retailer a closer substitute that switching to another retailer.”

**OFT’s response to the Parties on alternative payment methods**

227. MMF has misunderstood the nature of the previous discussion of alternative payment methods. The purpose of the discussion of alternative payment methods is to show that for some consumers there is likely to be a sufficiently strong preference for payment using a credit or charge card that, faced with the inability to pay using a credit or charge card or a surcharge for its use, the cardholder will choose to go to an alternative merchant rather than pay with an alternative payment method. In other words the purpose is to identify not the marginal consumers who would switch payment method but instead those consumers who, because of their valuation of a credit or charge card facilities or because of the lack of alternative suitable payment methods, would choose to purchase at a different merchant if they were not able to pay using their credit or charge card or were surcharged for using a credit or charge card. It is this latter group of customers who are most relevant to the merchant’s decision.

228. It is not necessary that all cardholders would change merchant or even that most cardholders would change merchants. As demonstrated in the examples above, even if only a small proportion of MasterCard credit cardholders, perhaps a fraction of one per cent, were to change merchant this may be sufficient to affect the acceptance decision or the surcharging decision of a merchant.

229. The OFT has considered carefully the survey evidence presented by MMF. This evidence is considered in more detail in Annex 10 (DotEcon discouragement survey) of this Decision. The survey considers cardholder responses to hypothetical choice situations. The OFT has a number of reservations about the methodology employed in the survey and the inferences drawn, and considers that the results should not be relied upon as precise estimates of the likely actual behaviour. However the results are indicative that a significant proportion of cardholders would change merchants in response to either a surcharge or the non-acceptance of cards. Table 8 shows the proportion of cardholders predicted to switch store in response to a two per cent surcharge from the conjoint analysis and the proportion responding that they would search for another store if faced with an unexpected surcharge.

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200 Paragraph 8 at Annex 5, Joint written representations on the SO.
Table 8: Percentage of cardholders searching for or switching to another store in response to a 2 per cent surcharge on credit cards

<table>
<thead>
<tr>
<th>Sector</th>
<th>Expected surcharge %</th>
<th>Unexpected surcharge %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular supply of groceries</td>
<td>[0-10]</td>
<td>[11-20]</td>
</tr>
<tr>
<td>A few groceries</td>
<td>[0-10]</td>
<td>[0-10]</td>
</tr>
<tr>
<td>CDs books, DVDs</td>
<td>[0-10]</td>
<td>[11-20]</td>
</tr>
<tr>
<td>Clothes</td>
<td>[0-10]</td>
<td>[21-30]</td>
</tr>
<tr>
<td>A restaurant meal</td>
<td>[0-10]</td>
<td>[11-20]</td>
</tr>
<tr>
<td>A snack in café/pub</td>
<td>[0-10]</td>
<td>[0-10]</td>
</tr>
<tr>
<td>Package holiday or plane tickets</td>
<td>[0-10]</td>
<td>[11-20]</td>
</tr>
<tr>
<td>Electrical appliance</td>
<td>[11-20]</td>
<td>[31-40]</td>
</tr>
</tbody>
</table>

Data in Column 1 is drawn from Table 4 at Annex 5 (Discouragement of credit card use: A study of merchants’ ability to affect customers’ choices of payment method), Joint written representations on the SO.

Data in Column 2 is drawn from Table 25 at Annex 5, Joint written representations on the SO.

230. Table 9 gives the proportion of credit cardholders who state that whether a store accepts a debit or a credit card is one of the most important factors in their choice of store. The Table also gives the proportion of credit cardholders who would switch store if the store did not accept credit or debit cards.201

201 In the survey the hypothetical merchant either accepted all cards or none, so the survey did not examine the effect of a merchant choosing to accept some but not all card schemes.
Table 9: Importance of card acceptance for store choice

<table>
<thead>
<tr>
<th>Item</th>
<th>Debit card acceptance important %</th>
<th>Credit card acceptance important %</th>
<th>Switch store if cards not accepted %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular supply of groceries</td>
<td>[0-10]</td>
<td>[11-20]</td>
<td>[21-30]</td>
</tr>
<tr>
<td>A few groceries</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
</tr>
<tr>
<td>CDs, books, DVDs</td>
<td>[0-10]</td>
<td>[11-20]</td>
<td>[11-20]</td>
</tr>
<tr>
<td>Clothes</td>
<td>[0-10]</td>
<td>[11-20]</td>
<td>[21-30]</td>
</tr>
<tr>
<td>A restaurant meal</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[21-30]</td>
</tr>
<tr>
<td>A snack in café/pub</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[11-20]</td>
</tr>
<tr>
<td>Package holiday or plane tickets</td>
<td>[11-20]</td>
<td>[21-30]</td>
<td>[41-50]</td>
</tr>
<tr>
<td>Electrical appliance</td>
<td>[0-10]</td>
<td>[10-20]</td>
<td>[41-50]</td>
</tr>
</tbody>
</table>

Data in Columns 1 and 2 is drawn from Table 1 at Annex 5, Joint written representations on the SO.
Data in Column 3 is drawn from Table 4 at Annex 5, Joint written representations on the SO.

231. The next two sections look in more detail at the potential for a merchant exiting the scheme or surcharging, or using some other form of discouragement, in response to a 5-10 per cent increase in MSCs above the competitive level.

Exiting: would merchants exit following a 5-10 per cent increase in an MSC?

232. The OFT has considered above the theoretical substitutability of different payment methods from the perspective of cardholders. In the light of this, it is necessary to consider whether, in practice, merchants would stop accepting MasterCard scheme cards following a 5-10 per cent increase in MSCs above the competitive level. In this respect if sufficient cardholders value certain of the characteristics of credit and charge cards highly as compared with other payment instruments, merchants would lose business to their competitors if they unilaterally refused to accept payment by them.

233. For the purposes of this investigation, if the MMF MIF (and, indirectly, MSCs) increased, there is a theoretical possibility that some merchants may stop accepting MasterCard credit and charge cards and switch to (or retain only) the Visa scheme. However, the OFT has received submissions from the BRC which support the view that, from the perspective of merchants, the Visa and MasterCard schemes are not substitutes for each other, i.e. they offer an additional rather than

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202 See paragraph 86, R14.
alternative payment method. This is consistent with the observation that virtually all merchants in the UK that accept MasterCard branded credit cards also accept Visa branded credit cards, and vice versa (see paragraph 217 above).

234. Evidence of the lack of substitution by merchants between the Visa and MasterCard schemes is also provided by considering the effects of the reduction in the Visa MIF that occurred in October 2003. If the Visa and MasterCard schemes were indeed close substitutes for this purpose, then the creation of a sustained price differential would be expected to lead to substitution. In fact, no such substitution appears to have occurred following the reduction in the Visa MIF.

**The reduction in the Visa MIF in October 2003**

235. The schedule for the Visa domestic MIF in the UK is similar in structure, but not identical, to the schedule set by MMF. Each schedule has a rate for [REDACTED] and a standard rate. There are, in addition, some other categories which are specific to each scheme. In 2001, the core categories of [REDACTED] and standard transactions accounted for more than 95 per cent of all domestic MasterCard transactions for which the interchange fee applied, by both value and volume. In March 2000, the interchange fees that applied for both the MasterCard and the Visa scheme for these core categories was the same. In October 2001, both schemes simultaneously introduced a [REDACTED] rate that was common to both schemes for [REDACTED]. The effect of this was that [REDACTED] would attract the same interchange fee from both MasterCard and Visa.

236. In October 2002, Visa introduced a lower rate for [REDACTED] and also [REDACTED]. Visa’s new schedule introduced in October 2003 included a further [REDACTED] and [REDACTED]. The [REDACTED] was also reduced in October 2003. The effect of the reductions was that, from October 2003 until October 2004, for certain key MIF categories the MasterCard interchange rate was between /10-25/ per cent higher than the rate applied for Visa transactions. MMF’s own interchange fee schedule

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203 The BRC has claimed that “...no retailer (and, so far as the BRC is aware, no major merchant in any sector) has chosen to accept cards issued under one of the major credit or debit card schemes and not the other” (see BRC submission (1 September 2000)). See also paragraph 3.101, the Cruickshank Report: “...once a payment scheme has reached critical mass, it becomes progressively difficult for retailers to refuse to accept that scheme’s cards, for fear of losing business to their competitors. Accepting all major card schemes is virtually a necessity for large sectors of UK retailing, even when the cards offer consumers very similar products”. Professor von Weizsäcker also acknowledges that whilst, as regards different credit card systems, purchasers choose between X or Y or Z, merchants will accept X and Y and Z: paragraph 52, Professor von Weizsäcker, Economics of Credit Cards, submitted as part of MCE/MCI Joint written representations on the R14 (23 January 2002).

204 Details of the MMF MIF schedule are presented in Table 1 of this Decision. The Visa domestic MIF schedule was supplied to the OFT in July 2004 in response to a request for information under section 26 of the CA98.

changed in October 2004. Table 10 summarises the relevant information on the MMF and Visa MIF rates.

Table 10: Visa and MMF MIF rates

<table>
<thead>
<tr>
<th>Date</th>
<th>March 2000</th>
<th>October 2001</th>
<th>October 2002</th>
<th>October 2003</th>
<th>October 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scheme</td>
<td>Visa MC</td>
<td>Visa MC</td>
<td>Visa MC</td>
<td>Visa MC</td>
<td>Visa MC</td>
</tr>
<tr>
<td>Standard</td>
<td>1.3 1.3</td>
<td>1.3 1.3</td>
<td>1.3 1.3</td>
<td>1.3 1.3</td>
<td>1.3 1.3</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>1.0 1.0</td>
<td>1.0 1.0</td>
<td>1.0 1.0</td>
<td>0.87 1.0</td>
<td>[0.76-1.00]</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>n/a n/a</td>
<td>0.9 0.9</td>
<td>0.9 0.9</td>
<td>0.77 0.9</td>
<td>[0.76-1.00]</td>
</tr>
<tr>
<td>[REDACTED]*</td>
<td>1.1 1.1</td>
<td>1.1 1.1</td>
<td>1.0 1.1</td>
<td>0.9 1.1</td>
<td>[0.76-1.00]</td>
</tr>
<tr>
<td>[REDACTED]</td>
<td>1.1 1.1</td>
<td>1.1 1.1</td>
<td>1.1 1.1</td>
<td>1.1 1.1</td>
<td>[1.01-1.25]</td>
</tr>
<tr>
<td>[REDACTED]**</td>
<td>1.3 1.3</td>
<td>1.3 1.3</td>
<td>1.3 1.3</td>
<td>1.3 1.3</td>
<td>[1.26-1.50]</td>
</tr>
</tbody>
</table>

* [REDACTED].  
** [REDACTED].

237. The reduction in the Visa MIF that took place in October 2003 offers a chance to examine the degree of substitutability between payment card schemes from the perspective of merchants based upon actual price differences between the schemes. Since October 2003, some key components of the MasterCard domestic fallback interchange fee schedule have been higher than those for Visa by a small but significant amount or greater.206 If there were a high degree of substitutability between the card schemes for merchants, one would expect that substitutability to be reflected in a significant number of merchants choosing no longer to accept MasterCard, or alternatively for merchants to elect to start accepting Visa but not MasterCard.

238. In considering the extent of substitution, it is important to recall (see paragraph 204) that many merchants were and still are offered a 'blended' MSC by their acquirers. Prior to October 2002, there was no incentive for acquirers to differentiate between schemes since the interchange fee schedules for the schemes were the same for the large majority of transactions. After October 2002, a differential interchange rate applied to [REDACTED] transactions. Thus, there developed an incentive to de-blend, in particular for certain types of merchants who predominantly accept [REDACTED] transactions (e.g. [REDACTED]). In October 2003, this incentive became substantially greater as a much larger proportion of

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206 After October 2003, the MMF MIF for [REDACTED] transactions was [10-25] per cent higher than the Visa MIF. For [REDACTED] transactions the MMF MIF was [10-25] per cent higher than the equivalent Visa MIF. For [REDACTED] transactions the MMF MIF was [10-25] per cent higher than the equivalent Visa MIF.
transactions, including the [REDACTED] transactions that constitute the majority of transactions, became subject to differential interchange fees. 207

239. The extent of blending is important because if a merchant faces the same MSC for Visa and MasterCard transactions it has no incentive to substitute between the schemes. Effectively, when faced with a blended MSC, the choice for a merchant is whether to accept Visa and MasterCard credit and charge cards rather than whether to accept Visa or MasterCard credit and charge cards.

240. Evidence has been provided by the main banks that operate as acquirers for Visa and MasterCard. For the first half of 2003, i.e. after a MIF differential emerged for [REDACTED] transactions but not for other types of transactions, seven acquirers reported that at least 98 per cent (in the case of some acquirers 100 per cent) of merchants faced a blended MSC. 208 In 2004, after a more substantial differential between the MasterCard and Visa MIF was created, it remained that the majority of acquirers reported that the proportion of merchants that faced a blended MSC was unchanged, i.e. still 98 per cent or greater.

241. Where, subsequent to the fall in the Visa MIF in October 2003, an acquirer offered MSC rates with a differential between Visa and MasterCard credit and charge cards (i.e. merchants no longer faced a blended MSC), this was usually the case only in respect of the larger merchants. 209 However, a key point is that despite the existence of the differential MSC for some merchants, according to acquirers, not one merchant chose to accept Visa credit and charge cards but not MasterCard branded cards. This provides strong and direct evidence that an increase in an MSC for MasterCard credit and charge card transactions relative to an MSC for Visa credit and charge card transactions does not lead to any substitution by merchants between schemes. In addition, the continued widespread use of blended MSCs despite the existence of a significant differential in MIFs between the Visa and MasterCard schemes reinforces the OFT’s view that substitution by merchants between these credit card schemes is unlikely to constrain an increase in the MMF MIF.

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208 Responses to an information request (9 July 2004) to the main MasterCard acquirers in the UK made under section 26 of the CA98. Responses were received between July and October 2004.

209 In paragraph 3.24, Joint written representation on the SO, MMF states that “for three of five main UK acquirers, a significant majority of MasterCard transactions and MasterCard MSC revenues are now accounted for by unblended rates. Indeed, in the UK, well over half of all MasterCard transactions and MasterCard MSC revenues are now accounted for by unblended rates.” This statement is not inconsistent with the observation that 98 per cent of merchants do not face blended MSCs. The largest retailers, including supermarkets and high street chains, may account for a significant proportion (potentially the majority) of transactions but may constitute a very small proportion of the number of merchants that accept cards.
Acceptance of debit cards

242. By comparing the level of the domestic MIF charged for debit cards with the MMF MIF, it is clear that the prevailing level of debit card MIF does not place a constraint on the MMF MIF. For example the MIF rate for Visa debit cards ranges from [0-10] pence per transaction for a [REDACTED] transaction to [71-20] pence per transaction for a standard transaction.\(^{210}\) These rates apply irrespective of the value of the transaction. For an average credit card transaction of £60, the MMF MIF rate payable would be [45-60] pence for an [REDACTED] transaction and [75-90] pence for a standard transaction. That the MMF MIF is set at a level between *five and eight times greater* than the Visa debit card MIF for an equivalent transaction indicates that the Visa debit card MIF does not constrain the MMF MIF.

The level of the MMF MIF/MSCs and merchant exits

243. The BRC has told the OFT that the withdrawal by merchants from the payment card schemes is not a credible option because, in some ways, the major card schemes have become ‘essential facilities’.\(^{211}\) If this is true, then it would support the OFT’s view that merchants would not switch away from the MasterCard credit and charge card scheme in the event of a 5-10 per cent increase in the MMF MIF above the competitive level (or equivalent increase in MSCs) and so the relevant product market should not be widened to include other payment methods.

244. In order to determine whether merchants would exit, the OFT has examined the relationship between the level of the MMF MIF and the number of merchant exits.

245. In its individual oral representations on the R14, RBSG highlighted the findings of its own questionnaire, in which merchants no longer requiring acquiring services were asked for their reasons for exiting.\(^{212}\) Of the [REDACTED] exits recorded in 2001, [REDACTED] merchants stated that they no longer wished to accept credit cards.\(^{213}\) At the OFT’s request, MMF then provided information on the average levels of MIF, MSCs and the number of merchant exits, in order to help establish whether there was any link between merchants exiting and the level of the MMF MIF and MSCs.\(^{214}\) MMF pointed to a high negative correlation between the stock of merchants and average MSCs (coefficient of correlation of

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\(^{210}\) Annex to a Letter from Visa to the OFT (1 April 2003).

\(^{211}\) See also footnote 203 above.

\(^{212}\) Mr Stephen Brannan: page 5, Transcript of RBSG oral representations on the R14 (6 February 2002).

\(^{213}\) Letter from Allen & Overy to the OFT (1 March 2002) in response to the OFT information request under section 26 of the CA98. In its reply, RBSG acknowledged that the reason for each merchant’s decision is not recorded and that it could not say to what extent, if at all, the merchants’ decision to stop accepting cards could be attributed to changes in the level of the MSC.

\(^{214}\) See further Annex 12 of this Decision.
215 as evidence of the ability of a high MSC to cause merchants to leave the scheme.216

246. MMF also provided the OFT, at the OFT’s request, with quarterly data between 1996 and 2001 on the total stock of merchants accepting MasterCard payments (rather than the number of exits) and the average MIFs and MSCs for the major acquiring banks [REDACTED]. MMF also provided the OFT with a similar version of Figure 4 below containing average MSCs, MIFs and total merchant stock.

Figure 4: Stock of merchants vs average MSCs and MIF

247. As a general comment, it is widely accepted that correlation and regression statistics can give rise to spurious and misleading results and must be treated with caution.217 Whilst the correlation coefficient identified by MMF for the stock of merchants and MSC levels was [REDACTED], any two series that follow a linear trend, one series upward and one series downward, for whatever reason, would have a negative correlation coefficient of close to -1. Therefore, a great number of data series unrelated to merchant stock would also offer a high correlation coefficient, providing their trend was reasonably linear. This statistic alone clearly does not imply that MSCs have affected the stock of merchants accepting payments.

248. One econometric technique that can be used to examine whether one series is affected by another is 'Granger causality'. This technique tests whether events in one series tend to precede effects in another. Although it still cannot prove that a causal relationship exists, a positive result is at least suggestive of it. A negative result certainly makes it less likely that a clear causal relationship is actually present between two variables.

249. Annex 12 (Evidence on correlation between merchants exiting and the level of the MMF MIF/MSCs) of this Decision shows the results of the OFT testing each of the three series against the others. There appears to be no evidence in the data available to suggest that the levels of MIF or MSCs have a direct effect upon the number of merchants accepting MasterCard credit and charge cards.218

250. To underline that the simple relationship between merchant stock, MIFs and MSCs quoted by MMF states little about causality, the OFT has used

215 A correlation coefficient is a measure of the degree of association between two variables and lies between 1 and –1. If the two variables are statistically independent, the correlation coefficient between them is zero.
216 Letter and e-mail from Denton Wilde Sapte to the OFT (21 March 2002).
218 These results are based on the fairly short series of data made available to the OFT.
regression analysis to evaluate a model designed to explain the stock figures in terms of other explanatory variables. Average household expenditure is included as a variable that may influence the stock of merchants accepting credit cards, but it is also included as a variable that has a close relationship with the stock simply by virtue of the straight upward trend in the data set.219

251. The results of the estimation show that the estimated coefficient for the average MSC variable is not statistically significant (see Annex 12 of this Decision).220 This result gives further evidence that a change in MSCs would have an insignificant impact upon the number of merchants accepting MasterCard credit and charge cards in the UK.221 The OFT estimated a similar model using the MMF MIF as an explanatory variable and again the results suggest that the level of the MMF MIF has little, if any, impact on the number of merchants accepting MasterCard credit and charge cards (see Annex 12 of this Decision).

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219 The use of this variable is illustrative and the OFT recognises that there may be better variables than average household expenditure in explaining merchant stock.

220 The dependent variable is the stock of merchants.

221 MMF argues that the lack of a negative and statistically significant relationship between MSCs and the stock of merchants is the result of variance (noise) in the data, which is too high to allow the underlying relationship between the two variables to be discerned (see paragraph 3.3.27, Joint written representations on the SR14). The OFT accepts that this is a potential alternative interpretation and observes that under either interpretation, the data offer no evidence that a change in MSC would affect the number of merchants accepting cards.
MEPUK/ORC Merchant survey

252. MMF claims that its MEPUK/ORC merchant survey\textsuperscript{222} shows that merchants consider credit and debit cards, cheques and cash to be direct substitutes for each other.\textsuperscript{223} MMF also concludes that the agreement on setting the MMF MIF does not confer enough market power on its members to satisfy the hypothetical monopolist test, due to the willingness of merchants to surcharge following an increase in MSCs (see paragraphs 277-278 below).

253. Question 8 of the survey asks, “suppose that all credit card acquiring banks, including your current one, increased their fees to merchants on credit card transactions by 10%. Which of the following are you most likely to do?”. The analysis was subdivided into merchants by turnover and the results are set out in Table 11 below.

\textsuperscript{222} Appendix 5 (MEPUK/ORC merchant survey, October 2001) submitted as part of MMF representations on the R14 (18 January 2002).

\textsuperscript{223} Paragraphs 3.2.27-3.2.30, Joint written representations on the SR14.
<table>
<thead>
<tr>
<th>Turnover</th>
<th>Less than £1m</th>
<th>£1m to £2m</th>
<th>£2m to £5m</th>
<th>£5m to £10m</th>
<th>£10m to £20m</th>
<th>£20m or more</th>
<th>All Merchants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of merchants</td>
<td>40</td>
<td>85</td>
<td>86</td>
<td>77</td>
<td>64</td>
<td>86</td>
<td>505</td>
</tr>
<tr>
<td>Exit: stop accepting credit cards</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[11-20]% ([REDACTED])</td>
</tr>
<tr>
<td>Surcharge: charge customers an extra fee for paying by credit cards</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[31-40]% ([REDACTED])</td>
</tr>
<tr>
<td>Try to dissuade customers from paying by credit card</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[11-20]% ([REDACTED])</td>
</tr>
<tr>
<td>Take none of these actions</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[21-30]% ([REDACTED])</td>
</tr>
<tr>
<td>Don’t know</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[0-10]% ([REDACTED])</td>
</tr>
<tr>
<td>Refused</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[REDACTED]</td>
<td>[0-10]% ([REDACTED])</td>
</tr>
</tbody>
</table>

224 Note: 67 merchants refused to provide details of their turnover or responded don’t know.
254. Table 11 shows that [REDACTED] indicated that they would stop accepting credit cards if MSCs were increased by 10 per cent. Of these:

- [REDACTED] per cent indicated that they would prefer to receive payment by debit cards instead;
- [REDACTED] per cent by own store card;
- [REDACTED] per cent by cheques;
- [REDACTED] per cent by cash; and
- [REDACTED] per cent by another payment method.225

255. The OFT does not agree with the conclusions that MMF has drawn from the survey. In addition, the OFT can give little weight to this type of survey evidence. Indeed, MMF concedes that the surveys were not designed to estimate elasticities in the market for use in the hypothetical monopolist type of analysis.226

256. First, it is notable that in MMF’s questionnaire no option is directly provided for the merchants to do what the OFT thinks is the most rational option when faced with a small but significant increase in MSCs, i.e. whether they would incorporate the applicable MSC into their prices and spread out the costs so as to make them invisible.227

257. Second, problems arise in this type of survey evidence which are analogous to the difficulties faced by the hypothetical monopolist test owing to the ‘cellophane fallacy’. If the Parties have already exercised their market power so that the MMF MIF (and, consequently, MSCs) lies above the competitive level, then assessing the reaction of merchants to an increase in MSCs through the questionnaire could provide misleading evidence on the constraints on their market power.228

258. Third, question 8 of the survey may have given respondents a misleading impression about the size of the proposed increase by referring to the cost implications of an increase in MSCs of 10 per cent. It is quite possible that their answers may have differed if it had been explained to them that such a 10 per cent increase would only have resulted in a marginal increase in

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225 See Question 9, MEPUK/ ORC merchant survey. It is not at all certain to the OFT how merchants would encourage cardholders to use their preferred method of payment or whether they would be successful.

226 Dr Helen Jenkins: pages 101-102, Transcript of MMF oral representations on the R14 (5 February 2002).

227 The survey option of “take none of these actions” is insufficiently clear to show that merchants would pass on the MSC increase in their prices. For example, it could be interpreted as merchants allowing the MSC to cut into their margins with no change in retail prices. The OFT is not persuaded by MMF’s claim (see paragraph 3.3.24(b), Joint written representations on the SR14) that there is no reason to believe that merchants would overlook the option of raising prices in their responses when they were not given this as a choice in the list of options to which they had to respond.

228 MMF argues that the cellophane fallacy does not apply because of the competitive pressures faced by credit card schemes (see paragraph 3.3.24(e), Joint written representations on the SR14). The OFT does not accept that the MIF is subject to competitive constraints, see paragraph 144 of this Decision.
their MSC (for example, an MSC of 1.5 per cent would only rise to 1.65 per cent). MMF has stated that it is highly unlikely that responding merchants misinterpreted the question. Nevertheless the OFT believes that the question is unclear and open to alternative interpretations.

259. Fourth, the OFT considers that any conclusions derived from survey evidence in these circumstances must be treated very carefully, because people often over-estimate their responses, especially in the short-term. Whilst interview techniques may be used to provide evidence on substitutability for the purposes of market definition, answers need to be treated with a degree of caution, because of the hypothetical nature of the questions. Empirical evidence based on past experience will generally be valued more highly by the OFT than questionnaire-based predictions of future actions.

260. Fifth, MMF has not provided evidence that it has adequately captured the strategic interaction between merchants. It is clear from the evidence of the BRC that for a merchant to exit a card scheme unilaterally is a very different proposition from all merchants exiting simultaneously. Cardholders value highly the functionality of credit cards (see paragraphs 216-223) and, if a merchant unilaterally exited a scheme, it could expect to lose custom to its competitors. It is the BRC’s view that exiting a scheme would only be profitable for merchants if it were conducted collusively.

Summary on Exiting

261. The evidence reviewed by the OFT, including the Parties’ representations, supports the view taken by the OFT that merchants would not switch away from accepting MasterCard branded credit and charge cards to other forms of payment methods in sufficient numbers to constrain a hypothetical monopolist from raising an MSC by 5-10 per cent.

Surcharging: would merchants surcharge following a 5-10 per cent increase in an MSC?

262. The OFT has considered whether cardholders are willing to be surcharged for using their branded credit or charge card. This is because a merchant’s ability to pass on increases in the MMF MIF and an MSC by surcharging will depend on the reaction of their cardholder customers. A cardholder who is unwilling to be surcharged will be unwilling to use his or her credit and charge card when such a surcharge is in place. This places doubt on the ability of merchants to surcharge in the first place, as they could expect to lose business to their competitors who did not surcharge.

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229 Paragraph 3.3.24 (c), Joint written representations on the SR14; paragraph 38 at Annex 1, Joint written representations on the SO.
230 Paragraph 3.7, OFT403 Market Definition (December 2004).
231 MMF argues that there is no reason to believe that the merchants are not capable of taking this into account when responding to this question (see paragraph 3.3.24, Joint written representations on the SR14).
232 See footnote 203.
263. The OFT has also considered evidence on why merchants who surcharge choose to do so and why others choose not to. This evidence indicates that, in large part, those merchants that surcharge are restricted to certain sectors and/or surcharge for reasons that are unrelated to the level of the MMF MIF or MSCs.

264. The OFT is not convinced by MMF's evidence which purports to show that merchants would surcharge in the event of a small but significant increase in the MMF MIF or MSCs. In fact, in the evidence submitted by MMF, the OFT has found support for its view that merchants would not surcharge.

**FACTS International Merchant Study**

265. In June 2004, the OFT commissioned a survey from FACTS International Limited into the attitudes of UK merchants to surcharging. 1,000 merchants that accepted credit cards were chosen from a stratified random sample of small and medium-sized merchants in the UK, and were interviewed in July and August of 2004. The results of this survey must be interpreted in the context that the level of MSCs that merchants faced at the time of the survey may be significantly above the competitive level as a result of the MMF MIF agreement. Hence, the extent of surcharging observed may be expected to be greater than that which would prevail if MSCs were set at a competitive level.

266. The survey confirmed that the large majority of surveyed merchants, 86 per cent, do not levy a surcharge. The survey also confirmed that most of these merchants believed that the potential loss of customers if they surcharged would deter them from doing so. For example, over half of merchants who accept credit cards stated that they do not surcharge because they would lose customers if they did. For almost all of these merchants this was the main reason for not surcharging.

267. It is estimated from this survey that 14 per cent of small and medium-sized merchants who accept credit cards surcharge some or all transactions made by credit card. However, this figure may significantly overstate the proportion of transactions on which a surcharge is levied for two reasons. First, the survey focused on small and medium-sized merchants and did not look at the major high street retailers or supermarkets. These larger retailers do not in general surcharge. Second, only 4 per cent of merchants who accept cards (and less than a third of those merchants who surcharge) indicated that they levied a surcharge on all credit card transactions. The remaining merchants who levy a surcharge only surcharged selected types of transactions. 6 per cent of surveyed merchants only surcharged transactions below a certain value.

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233 The sampling frame from which the merchants were drawn does not include the very largest merchants, those with annual turnover greater than £30m.
234 Details of the survey are contained in Annex 6 (FACTS International Merchant Survey) of this Decision.
235 Table 15, FACTS International Merchant Survey.
and 3 per cent of surveyed merchants only surcharged transactions above a certain transaction value. The remaining one per cent of surveyed merchants, surcharge selectively according to some other criteria.

268. The selective nature of surcharging further confirms the OFT’s view that a substantial increase in surcharging would not occur in the event of a small but significant increase in the MMF MIF or MSCs above the competitive level.

269. Six per cent of surveyed merchants who accept credit cards, slightly under a half of those who surcharge, only surcharge low value transactions. The median value of transactions below which these merchants surcharge is £10. Merchants may also discourage credit card transactions by setting a minimum transaction value below which they will not accept credit cards. The merchant survey commissioned by the OFT indicates that 45 per cent of small and medium-sized merchants who accept credit cards set a minimum transaction value for credit card transactions and the median value set for the minimum transaction is £5.

270. However, the OFT does not believe that the incidence of such surcharging or discouragement of low value transactions is related to the level of MSCs. All of the acquirers in the UK have confirmed to the OFT that they do not impose a minimum per transaction level of MSCs for small value credit or charge card payments that would lead to such discouragement. MSCs are levied as a fixed proportion of the value of the transaction. The level of the current average MSC a merchant would pay for a transaction of £5 is less that [5-10] pence and for a transaction of £1 is less than [0-5] pence. Such sums, which are likely to be lower for most merchants than the per transaction fee for accepting a debit card transaction cannot account for the discouragement of small value transactions.

271. It is more likely that such discouragement and surcharging of low-value transactions occurs because of non-MSC costs, such as the time costs of processing and authorisation. Confirmation of this view is provided by the fact that 80 per cent of those who surcharged credit cards for low-value transactions also surcharged debit cards, a figure which falls to 48 per cent for all surveyed merchants who surcharge. In addition, for low-value transactions, cash is likely to be a more effective substitute for many consumers, who may also be more disinclined to switch to another retailer for such a low value transaction. These factors would not be affected by a small but significant increase in the level of MSCs above competitive level.

236 Table 22, FACTS International Merchants Survey.
237 The mean value is £8.45 (see Table 24, FACTS International Merchant Survey.
238 Table 32, FACTS International Merchant Survey.
239 In paragraph 281 below, the OFT notes that one sector where surcharging may occur frequently is taxis. The average UK fare for a standard taxi journey is £3.93 (see Table 6.1, OFT676 The regulation of licensed taxi and PHV services in the UK (November 2003)). Thus, this sector-specific charging may be regarded as a consequence of the low average value of transactions in this sector.
272. In addition, 3 per cent of small and medium-sized merchants who accept credit cards, approximately a quarter of those who surcharge, only surcharge transactions above a certain value. The median value of transactions above which these merchants surcharge is £1000.\(^{240}\) However, 90 per cent of this group of merchants were from the auto dealer and garages sector.\(^{241}\) For a high value transaction, the MSC payable may be £15 per £1000 of transaction value. For a merchant dealing in high-value transactions but operating on a fixed or low margin, such as car dealers,\(^{242}\) the viability of absorbing these card costs is lower than for other types of merchants. The OFT does not believe that the effect of a small but significant increase in MSCs above the competitive level on this type of surcharging would be substantial.\(^{243}\) Only certain types of merchants, of the type described, would consider surcharging in this way, and other types of merchants who do not frequently deal in such high value transactions or for whom margins may be higher, are unlikely to adopt such a surcharging practice. In addition, the extent of such surcharging by these merchants, albeit limited as it is, may well have been inflated by the incidence of an MSC above competitive levels due to the agreement on the MMF MIF.

**Oxera discouragement survey**

273. MMF commissioned the Oxera discouragement survey on whether credit cardholders experience any form of discouragement when using credit cards.\(^{244}\) This survey indicates that in the overwhelming majority of cases credit card holders do not experience discouragement practices. In only one of the sectors considered by the survey, travel agents, did a substantial minority of credit cardholders experience discouragement, in this case in the form of surcharging. In all other sectors cardholders were not expected to pay a surcharge for using a credit card in over 95 per cent of cases. In addition to surcharging, two forms of discouragement were experienced by more than two per cent of cardholders in some sectors, a minimum payment value and encouragement to use a store card. As indicated above (see paragraph 268-270 above) the decision to levy a minimum payment is unlikely to be affected by the level of MSCs charged. Encouragement to use a store card is not specifically targeted at credit card holders and is related to the benefits to a store of store card use rather than the level of MSCs for credit cards. Therefore neither of these two forms of discouragement is likely to be significantly affected by a

\(^{240}\) The mean value is £1175 (see Table 23, FACTS International Merchant Survey).

\(^{241}\) Indeed the remaining firms who surcharged above a set transaction value, which were from different sectors, surcharged all transactions over amounts varying between £1 and £10. Therefore they may be more appropriately classified as surcharging (nearly) all transactions (see Table 23, FACTS International Merchant Survey).

\(^{242}\) Travel agents are another sector where merchants may possess these features and are reputed to be more inclined to surcharge, see paragraph 281 below.

\(^{243}\) As a result of its concerns regarding both the cellophane fallacy and the validity of merchants’ responses to hypothetical questions about proposed price increases, the OFT did not include such hypothetical questions in its own survey.

\(^{244}\) See Annex 4 ([Survey of cardholders’ experience and response to merchant discouragement](#)), Joint written representations on the SO.
small increase in MSCs above the competitive level. Table 12 provides the
details of the experience of discouragement by credit cardholders.
Table 12: Discouragement practices encountered by cardholders (%)

<table>
<thead>
<tr>
<th></th>
<th>Credit Card not accepted</th>
<th>Any form of discouragement</th>
<th>Surcharge</th>
<th>Minimum payment</th>
<th>Asked for alternative payment method</th>
<th>Discount for cash</th>
<th>Store card</th>
<th>Discount for store card</th>
</tr>
</thead>
<tbody>
<tr>
<td>Travel agents</td>
<td>[0-10]</td>
<td>[41-50]</td>
<td>[41-50]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Department stores</td>
<td>[0-10]</td>
<td>[11-20]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
</tr>
<tr>
<td>Restaurants /cafes</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>[0-10]</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Petrol stations</td>
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<td>Pubs/bars</td>
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Source: Table 4 at Annex 4, Joint written representations on the SO.
274. The conclusion the OFT draws from this survey is that surcharging is the only method of discouragement that cardholders encounter to any significant extent. However, except when purchasing from a travel agent, the vast majority of credit cardholders are not asked to pay a surcharge for using a credit card.

**DotEcon discouragement survey**

275. MMF has also presented evidence in the form of a survey of the stores which cardholders choose to purchase from, and the extent to which this choice is influenced by discouragement. MMF notes from this survey that surcharging credit card use does lead to an overall loss of sales by merchants, although this effect is small compared to the reduction in credit card sales as a result of surcharging. The predicted loss of total sales by a merchant who levies a surcharge of 2 per cent on credit card transactions is between $0-20$ per cent, depending upon the sector and the context in which the surcharge is levied. MMF does not draw any conclusions from the results of this analysis as to whether surcharging is profitable or not.

276. The OFT has considered this survey in detail in Annex 10 of this Decision. Some results from this survey have been reported in paragraphs 229-230 and Tables 8 and 9 above. The OFT notes that it is not possible to draw conclusions from this survey as to whether surcharging is profitable or not. However the OFT believes that the results presented in Tables 8 and 9 support the OFT’s view that a significant and non trivial proportion of cardholders would switch store when faced with a surcharge or a merchant who did not accept the card.

**MEPUK/ORC Merchant Survey**

277. The MEPUK/ORC merchant survey indicated that some $>25$ per cent of merchants would surcharge following an increase in MSCs of 10 per cent. The OFT has already explained why this result is of limited use, in particular because of the cellophane fallacy, and documented the limitations of this survey (see paragraphs 255-260 above).

278. Furthermore, there is an additional reason why the OFT considers that the results of the MEPUK/ORC merchant survey are unreliable to the extent that little weight can be placed upon them. The imposition of surcharges by a minority of merchants would be irrational if cardholders were unwilling to be surcharged. Many cardholders value highly the functionality of credit and charge cards as compared to other payment instruments (see paragraphs 216-224 above). Therefore, if faced with a surcharge on the use of a credit or charge card by a minority of merchants (which is what the results of the MEPUK/ORC merchant survey, overstated as they are, suggest at their highest), the reaction of a significant proportion of cardholders would be to make their purchases

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245 Tables 7 and 26 at Annex 5, Joint written representations on the SO.
246 Paragraph 134 at Annex 5, Joint written representations on the SO.
247 Table 11 above.
with a credit or charge card at a merchant which did not surcharge, rather than switch to another payment instrument.

**Other representations and submissions**

279. The OFT finds further support for its position in the BRC’s submission in relation to the difficulties and additional costs associated with surcharging.248 According to the BRC, surcharging would lead to significant customer service costs, due to confusion arising about what rate of surcharging applies to which card. This would cause confusion, delays, disputes and complaints. The BRC believes that it is merchants who would face the brunt of public dissatisfaction with such difficulties and the associated customer service costs. Furthermore, it believes that sales costs would rise, due to merchants operating a dual pricing system because of changes required to POS systems, customer information and staff training. For these reasons, the BRC has told the OFT that it does not see surcharging as an effective option for merchants in response to an increase in MSCs.

280. The submission of the BRC is supported by the findings of the *Cruickshank Report*, which concluded that the reason why surcharging by retailers is uncommon is likely to be because the costs to individual retailers from surcharging are high. First, sales processes and practices would have to be changed. Second, surcharges are likely to be unpopular and a merchant who did surcharge would risk losing business to its competitors.249 This provides further support for the OFT’s view that surcharges would have to be imposed across the board, at least within individual product sectors, for merchants to be able to introduce them effectively.

281. Lastly, the OFT considers that the relative rarity of surcharging by merchants in the UK is itself evidence that it is unlikely to be a viable option for many merchants.250 PricewaterhouseCoopers (‘PwC’), on behalf of MCE/MCI, note that transaction charges (i.e. surcharges levied on users of credit cards for purchases) are generally zero in the UK,251 while MMF itself has identified that surcharging is only carried out by some sectors in the UK, such as taxis, ticket agencies and travel

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248 BRC submission,(1 September 2000).
249 Paragraph D3.1.28, *Cruickshank Report*.
250 See also evidence from merchant surveys carried out by the Commission in Sweden and the Netherlands, which found that only 5 and 10 per cent of merchants respectively choose to surcharge, even though it is permitted. The main reason for merchants deciding not to surcharge was that they thought there would be a negative cardholder reaction, leading to loss of customers: paragraph 55, Case Comp/29.373 *Visa International* OJ [10.11.2001] L293/24. MMF also acknowledges that this was the main reason for not surcharging, but states that additional factors were that (i) merchants considered it part of the service not to surcharge and (ii) there was low awareness that the ‘no discrimination rule’ had been abolished (see paragraph 3.3.35(b), Joint written representations on the SR14).
Again, the fact that surcharging appears to be concentrated within these particular sectors tends to confirm that it needs to be widespread across a particular product or service sector in order to be viable.

The Parties' response on merchant discouragement

282. In addition to the evidence considered in paragraphs 273-278, MMF has argued that the OFT's position on surcharging is wrong from a theoretical perspective.253 It argues that the fear of losing sales to other merchants or the actual loss of sales by a surcharging merchant cannot explain the reluctance of merchants to surcharge and is inconsistent with micro-economic theory.254 This is because, given any difference in the costs of different payment methods, it will be profitable to charge different prices for purchases made with those different payment methods. MMF has argued that the reluctance to surcharge cannot be attributed to consumers reacting in a different way to a surcharge to a normal price change. First it states that this would be irrational.255 Secondly, Professor von Weizsäcker, who labelled this consumer reaction “price perception bias”, has argued that this raises the intensity of competition between payment methods and is therefore not an argument for narrowing the relevant product market.256

283. Instead, Professor von Weizsäcker argues that the relative absence of surcharging is instead explained by the administrative costs of surcharging.257 Furthermore, Professor von Weizsäcker argues that these administrative costs of surcharging are relatively uniform across retailers, and that therefore at some critical level of an MSC many retailers will start to surcharge.258 The threat of such widespread surcharging, which Professor von Weizsäcker argues hurts the credit card schemes to a much greater degree than it hurts the merchant, constrains the MMF MIF.259 Therefore surcharging and other forms of discouragement represent a sufficient constraint on the MMF MIF that it cannot be raised above the current level.

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252 Paragraph 6.3.18, MMF written representations on the R14 (18 January 2002). Paragraphs 270-271 above have provided some explanations for why surcharging may be largely restricted to certain sectors.

253 Paragraph 4 at Annex 5, Joint written representations on the SO.

254 Paragraph 59 at Annex 5, Joint written representations on the SO and page 15, Some Economics of the Interchange fee, a report by Professor von Weizsäcker, (23 February 2005) (The 'Weizsäcker Report'). This report was commissioned by MCI and was submitted jointly by MCI/MCE and MMF as part of their Joint written representations on the SO.

255 Paragraph 61 at Annex 5, Joint written representations on the SO.


**OFT’s position on merchant discouragement**

284. The OFT recognises that there are costs of surcharging for merchants. These costs can take a variety of forms, such as the administrative costs of amending tills and computer systems to calculate different prices and the staff and time costs of informing each customer who wishes to pay by credit card of the existence and level of the surcharge and the alternative payment options with, if any, the level of surcharge attached. These costs are significantly broader than the narrow cost of changing accounting procedures and computing systems considered by Professor von Weizsäcker. There has been no evidence supplied to support the contention that the costs of surcharging are as narrow as indicated by the Parties in their representations.

285. Furthermore the Parties do not explain how the administrative costs of surcharging, which are alleged to be uniform across merchants (but again no evidence on this is supplied), can explain two observed features of surcharging behaviour. First, that surcharging is much more common in some sectors than in others. Secondly, that the majority of merchants which surcharge credit cards only do so selectively. If the costs of surcharging are largely the costs of changes to computer systems then administrative costs alone cannot explain selective surcharging.

286. The OFT believes that the profitability for merchants of levying a surcharge depends upon both the costs of surcharging and also the perceived customer response to surcharging. Consumer responsiveness, consumer search costs, seller uncertainty and imperfect information can all explain the existence of price rigidities. Such explanations of price rigidities can explain why it may be profitable for a firm to charge the same total price to the consumer irrespective of the payment method used, and therefore not surcharge, even when the costs to the retailer of different payment methods vary. Such circumstances may occur, for example, if consumers react differently to the imposition of a surcharge as against a general increase in price. This may be because, for reasons of transparency, a merchant will draw the consumer’s attention to the surcharge but not to the existence of a normal price differential with another merchant. This may also be because some consumers may be antagonised by the surcharge or perceive the surcharge as a deviation from some expected norm or an ‘unfair’ attempt to price discriminate between credit card holders and other types of customers.

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260 Paragraph 90, The Weizsäcker Report. A recent academic study of the costs of changing prices, which contains many similarities with the costs of surcharging since it involves the decision to introduce a price differential, found that these administrative costs of changing prices were a small proportion of the total costs of changing prices. See Zbaracki et al (2004) 'Managerial and Customer Costs of Price Adjustment', *Review of Economic Statistics*, 86, 514-533.

261 In addition factors such as the retail margin will also come into the calculation.


263 Zbaracki et al,(2004) provides evidence that the unwillingness to antagonise customers is an important part of the explanation of firms not adjusting prices in response to cost changes.
287. MMF seeks to characterise this consumer response as irrational but Professor von Weizsäcker has pointed to the “framing effect” that is one explanation of such behaviour. Moreover, empirical evidence supplied by MMF shows that consumers may react more strongly to a surcharge than to an equivalent price differential. Results presented as part of the DotEcon discouragement survey indicate that, for each type of transaction, a two per cent differential in price between merchants has no statistically significant effect on the choice of merchant but the imposition of a two per cent surcharge by a merchant leads to a statistically significant reduction in the likelihood of choosing that merchant. Indeed, according to this survey, when confronted with an unexpected 2 per cent surcharge levied by a merchant, 15-25 per cent of credit card holders, on average, would look for another shop.

288. The evidence from the FACTS International Merchant Survey commissioned by the OFT in June 2004 also indicates that the fear of losing sales is an important factor in the decision not to surcharge. The most common reason given by merchants for not surcharging in the FACTS International Merchant Survey is that they would lose customers if they did surcharge. Evidence from this survey is consistent with the OFT’s view that customer reaction is an important factor, but not the only factor, influencing the level of surcharging.

289. In order to justify the validity of the flawed estimate from the MEPUK/ORC survey that over 25 per cent of merchants would start to surcharge in response to a small but significant increase in MSCs despite the relative rarity of merchant surcharging at present, MMF has presented a purely theoretical argument. Professor von Weizsäcker has sought to argue that administrative costs are the only factor relevant to the merchant’s surcharging decision. Furthermore since Professor von Weizsäcker conceives these costs very narrowly, as only the costs of amending computer systems, he concludes that there is a narrow “absorption range” such that a small increase in MSCs may lead to a large increase in the number of merchants surcharging at some critical but unobserved point.

290. The OFT does not accept the argument that the administrative costs of surcharging are the only relevant factors that would be considered by merchants. The OFT believes that the survey evidence supplied by MMF, the evidence of the FACTS International Merchant Survey commissioned by the OFT, and the views of the BRC indicate that merchants would legitimately have a concern for consumer reaction and loss of sales. In addition there is evidence that costs of surcharging can be more extensive and wide-ranging than conceived by Professor von Weizsäcker (see paragraphs 279-280 and footnote 260). As a result the OFT does not accept the theoretical argument that there would be a tipping effect such

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264 Paragraph 70, The Weizsäcker Report
265 Tables 16-23 at Annex 5, Joint written representations on the SO.
266 Table 25 at Annex 5, Joint written representations on the SO. The proportion varies, according to the type of transaction, between 0-10 per cent and 31-40 per cent.
that a small increase in MSCs above the competitive level would lead to a substantial increase in the number of merchants who would surcharge.

291. In summary, having considered a wide range of evidence on the prevalence and effects of surcharging and discouragement the OFT notes that:

- except for certain specific sectors, such as travel agents, the vast majority of merchants do not surcharge credit card transactions;
- the majority of those merchants that do surcharge credit card transactions only do so selectively;
- outside certain specific sectors, credit card holders only rarely experience discouragement of credit card use (including surcharging);
- significant proportion of credit card holders would switch merchants if faced by an inability to use their credit card or a surcharge for its use; and
- for the majority of merchants, the threat of losing customers is an important factor in choosing not to surcharge.

Additional evidence supplied by the Parties: MMF’s SSNIP test analysis

292. In response to the SR14, MMF submitted a further empirical SSNIP analysis of the relevant market, which was conducted on its behalf by Oxera. This analysis ("the Oxera SSNIP analysis") was based on survey information obtained by DotEcon based on a survey of 502 UK merchants that sell directly to consumers, the results of which were also presented by MMF in response to the SR14 (the "MMF Merchant Study").

293. The MMF Merchant Study applies econometric analysis to a survey of merchants, in order to establish the impact of changes in MSCs on the volume of transactions undertaken using credit cards (through merchants ceasing to accept credit cards and discouraging their use at the POS). The study attempts to answer the overall question of whether a hypothetical monopolist credit card scheme could profitably increase MSCs. The MMF Merchant Study estimates the elasticity of demand for credit card transactions with respect to MSCs to be between $-1.2$. This estimate would imply that if MasterCard and Visa were to increase their

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268 See Annex 1, Joint written representations on the SR14.
269 A quantitative survey of 502 UK merchants was undertaken by MORI. The survey included: questions related to merchant characteristics; a set of conjoint questions confronting merchants with choices between payment systems defined by key attributes; a set of conjoint questions relating to merchant views as to what particular features of payment systems contribute towards incremental expenditure by users; a set of questions relating to accepting additional payment methods or ceasing to accept existing payment methods; and a set of questions about the extent to which merchants would choose to discourage the use of payment systems in response to price changes.
MSCs by 10 per cent, the total value of transactions undertaken using the cards of these two schemes would fall by between /10-20/ per cent.

294. To ascertain the implications for market definition, the Oxera SSNIP analysis then tests whether a hypothetical monopolist credit card scheme would find it profitable to increase MSCs by 10 per cent.270 Whether a monopolist finds such an increase profitable depends not just on the elasticity of demand, but also on factors such as the percentage mark-up of price on cost of the monopolist for each transaction. In this case, Oxera calculated that the critical sales loss271 for a hypothetical card scheme monopolist for a 10 per cent price increase would be /0-10/ per cent.272 Since such a price increase would result in a sales loss of between /10-20/ per cent according to the study, MMF concludes that the monopolist would not find it profitable to increase the price and so other forms of payment should be included in the relevant market.

295. The OFT has examined the MMF Merchant Study carefully (see Annex 8 (The MMF merchant study) of this Decision) but considers that, owing to the nature of the survey and sensitivity of the results, very little weight or certainty can be attached to its conclusions.

296. First, and most importantly, the MMF Merchant Study does not overcome the conceptual difficulties faced by the hypothetical monopolist test arising from the 'cellophane fallacy' (see paragraph 184). If the Parties have already exercised their market power so that the MMF MIF (and, consequently, MSCs) lie above the competitive level, then assessing the reaction of merchants to an increase in MSCs through this study, and applying this to a SSNIP test, would provide misleading evidence on the constraints on the market power of the card scheme.

297. Secondly, the cellophane fallacy problem is compounded by more general problems associated with this type of survey. Annex 8 of this Decision explains that there is a high chance that the survey used by MMF suffers from response bias. Respondents to the survey have both strategic and psychological reasons to overstate their elasticity of demand. Strategically, it is better for respondents to state that they are price sensitive if they think the information gathered in the survey might affect the pricing strategies of acquirers. It also appears that the actual survey questions provided psychological 'cues' to influence the way the questions were answered.

270 See section 5.2 at Annex 3, Joint written representations on the SR14.
271 The idea behind critical loss analysis relies on hypothesising a percentage price increase, calculating a threshold loss in sales - a critical sales loss - associated with that value and testing whether a predicted sales loss attributable to such a price increase is larger than the critical level. If the predicted sales loss is larger than the critical value, then it is judged that the price increase would not be profitable and that the market definition should be broadened.
272 Based on both iso-elastic demand curves and linear demand curves and a price-cost margin of / > 20/ per cent.
298. Thirdly, the questions in the survey of merchants related to much larger changes in MSCs than are relevant to a SSNIP test (see Annex 8 of this Decision for further details). In a series of questions, merchants who currently accept credit cards were asked initially whether they would continue to accept credit cards if their current MSC were increased by 25 per cent. Depending on the surveyed merchant’s answers to initial questions, subsequent questions asked about the merchant’s continued willingness to accept credit cards in response to increases in MSCs of up to 100 per cent above the current level of MSCs. Only six of the 1402 merchants surveyed (that currently accept cards) were asked how they would respond to an increased MSC of between 5-10 per cent greater than their current MSC. The OFT does not believe that survey questions relating to much larger changes in MSCs above current levels are helpful in understanding how merchants would respond to a 5-10 per cent increase in the level of MSCs above the competitive level, which is the relevant benchmark.

299. Fourthly, it is not clear that the hypothetical scenarios employed in this survey bear a close relation to the reality faced by merchants. The survey included questions addressed to merchants who do not currently accept credit cards. These were attributed an MSC equivalent to a rate they could expect to be currently offered and then asked whether they would accept credit cards at a level 25 per cent higher than that initial rate. The OFT does not consider that asking a merchant whether he would accept cards when faced with an MSC higher than the rate at which he refuses to accept cards is informative for a hypothetical monopolist test. MMF notes that /<60/ merchants, out of 127 merchants in the sample who did not accept credit cards, responded that they would accept cards at the higher rate. MMF explains this apparent paradox by suggesting that the hypothetical attributes in the survey may induce a merchant to give a survey response that they would accept cards even when they do not accept cards in reality. This however indicates that the attributes in the hypothetical scenarios may be significantly different from those which a merchant actually faces in reality. Furthermore this gap between hypothetical attributes and the real world puts into question the relevance of the survey as a whole, not just the reliability of the survey responses given by merchants who currently do not accept cards.

300. The above points demonstrate that the estimates of the effects of an increase in MSCs on merchant acceptance and discouragement provided in MMF’s SSNIP test analysis cannot be relied upon as evidence to widen the relevant market.

The OFT’s conclusions on the wholesale and acquiring markets

301. Having considered the available evidence and the representations of the Parties, and for the reasons set out in detail at paragraphs 232-260, the OFT does not consider that a sufficiently high number of merchants would be likely to switch away or exit from accepting MasterCard branded credit

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273 Paragraph 13 at Annex 3 (The MMF Merchant Survey: A response to the OFT), Joint written representations on the SO.
and charge card schemes to relying only on other forms of payment methods, such that those other forms of payment methods should be included in the relevant wholesale and acquiring markets. Equally, the OFT does not consider that a sufficiently high number of merchants would be likely to surcharge, or otherwise discourage, their MasterCard credit and charge card customers in order to recover the increased costs of the MMF MIF which are passed on through MSCs, such that other forms of payment methods should be included in the relevant wholesale and acquiring markets (paragraphs 262-281). Instead, the likely response of merchants would be to pass the increased cost on to all of their customers through an increase in retail prices. The Commission made a similar finding in its Visa MIF decision, in which it concluded that, when faced with an increase in the Visa MIF and MSCs, merchants would recover the cost increase by increasing the prices for all goods as this would lead to a smaller fall in turnover than ceasing to accept Visa cards.\(^{274}\)

302. In the absence of such exiting or surcharging by merchants, cardholders would not face a substantially different choice between alternative payment mechanisms and so would continue to use their MasterCard credit and charge cards. If neither merchants nor cardholders would in any significant number reduce acceptance or usage of MasterCard branded cards in response to a small but significant increase in MSCs above the competitive level, then the behaviour of merchants and cardholders would not constrain an increase in the MMF MIF for the purposes of the hypothetical monopolist test. Therefore, the OFT believes that the relevant product markets for the consideration of the MMF MIF agreement are the provision of wholesale and acquiring services for MasterCard branded credit and charge cards.

303. The Commission left open the question of whether debit, charge and credit cards formed part of the same relevant product market in its Visa MIF decision.\(^{275}\) The OFT, however, does not consider that either debit cards or other branded credit and charge card schemes are sufficiently substitutable from the perspective of merchants with the MasterCard credit and charge card scheme to form part of the same relevant market. Nonetheless, the OFT notes that the inclusion of debit cards and other credit and charge card schemes within the relevant markets would not affect its conclusions on the appreciability of the restrictions.\(^{276}\)

The issuing market

304. In the absence of surcharging by merchants, the agreement on the MMF MIF does not impact directly on the fees paid by MasterCard credit and charge card cardholders. In addition, the OFT finds that substitution by cardholders in response to changes in the charges levied by issuers does not constrain an increase in the level of the MMF MIF. Indeed, to the extent that any increase in the level of the MMF MIF may lower cardholder

\(^{274}\) Paragraphs 48, 80 and footnote 39, Visa MIF decision.

\(^{275}\) Paragraph 52, Visa MIF decision.

\(^{276}\) See paragraph 507 below.
charges or increase cardholder benefits (see paragraph 156), the indirect
effect of an increase in the MMF MIF is to strengthen a cardholder’s
preference for using his or her credit or charge card at a merchant, relative
to other payment methods. However, to the extent that the agreement on
the MMF MIF may impact on consumer preferences for use of alternative
payment methods, and may therefore distort competition between
payment methods (see paragraphs 689-694), it is useful to consider the
substitutes open to cardholders.

305. Accordingly, the OFT has considered the options for substitutability by
MasterCard credit and charge card cardholders by examining the effects of
a small but significant increase in price above the competitive level by a
hypothetical monopolist issuer of MasterCard branded credit and charge
cards. The OFT has considered evidence on the response of credit and
charge card cardholders to changes in different elements of the price of
cardholding. In addition, the OFT has considered in detail the
representations made and evidence on cardholder substitution.277

306. The OFT has considered whether other payment methods should be
included in the relevant market. In assessing the profitability of an increase
in price by a hypothetical monopolist credit and charge card issuer, it is
first necessary to consider the various prices set by issuers. There are
several different sources of revenue to issuers, not all of which are levied
directly on cardholders. The sources of revenue include interchange
revenue, interest charges, late payment fees and annual fees. Interchange
revenue varies according to transaction value, interest revenue varies
depending upon interest-bearing balances, and annual fee revenue
depends upon the number of cardholders but not card usage. An increase
in one or more of these fees is likely to affect the way that a card is used
or accepted or the propensity for cardholders to hold interest-bearing
balances.

307. Many cardholders do not face any price for cardholding or card usage. For
example, a transactor who neither pays an annual fee, nor pays interest
would not face any charges for use of the card. Indeed, many transactors
will face a negative price for card usage; the prevalence of reward or
cashback schemes on credit cards means that the cardholders who benefit
from these schemes are, in effect, paid to use their card.278 In considering
whether a hypothetical profit-maximising issuer would increase price
above the competitive level, it is necessary to consider which of the
charges such an issuer would find it most profitable to increase.279

277 See, in particular, the PwC cardholder survey and the EPI (now MCE) SSNIP test
(submitted as part of MCE/MCI Joint written representations on the R14) and Annex 2
(DotEcon: Cardholder Study: A Response to the OFT) and Annex 3, Joint written
representations on the SR14.
278 The rewards may be in the form of air miles or exchange for goods or services (see
Annex 7 (Loyalty Schemes and Affinity Arrangements) of this Decision.
279 Not all of these charges are levied on charge card cardholders. In particular a charge
card does not involve interest payments since there are no revolving balances. The OFT
notes that charge card cardholders account for a small proportion of total cards issued
under the MasterCard scheme (see Table 1, APACS Plastic Card Review 2005 and
paragraph 3 above). The OFT also notes that, were a charge card cardholder to be faced
308. Economic theory suggests that a hypothetical profit-maximising monopolist credit and charge card issuer would choose to raise the element, or those elements, of price to which customers are least sensitive. Of the prices charged by issuers, all cardholders are least sensitive to changes in the level of the MMF MIF since they do not face this element of price directly. Cardholders would only be faced directly with an increase in the level of the MMF MIF if merchants were to surcharge. For reasons set out in paragraphs 262-291, the OFT believes that surcharging would not significantly increase in response to a small but significant increase in the MMF MIF above the competitive level. The OFT has already considered in detail whether a hypothetical monopolist issuer could profitably increase the MMF MIF above its competitive level. The OFT here considers the effect of increases in those elements of issuer revenue that are charged to cardholders, in order to assess the relevant substitutes to MasterCard branded credit and charge cards from the perspective of cardholders.

**Other Credit and Charge Card Schemes**

309. As a preliminary matter, the OFT has considered whether, when faced with an increase in cardholder charges, MasterCard branded credit and charge card cardholders would substitute to Visa branded credit and charge cards. Currently, a number of card issuers offer both MasterCard and Visa branded credit or charge cards on identical terms and conditions and with identical interest rates. While their cardholder customers will face different prices from different issuers, they will not currently face different prices for using a Visa branded credit or charge card relative to a MasterCard branded credit or charge card from the same issuer. Therefore, for the purposes of UK purchase transactions, Visa and MasterCard branded credit and charge cards may be regarded as substitutable from the perspective of cardholders. This suggests that the relevant market includes services provided by issuers to both MasterCard and Visa branded credit and charge card cardholders.

310. The OFT has also considered whether MasterCard and Visa credit and charge card cardholders would substitute to three-party credit and charge card providers such as Amex. Credit and charge cards offered by three-party systems such as Amex offer similar functionality to cardholders to that provided by the MasterCard and Visa branded cards. However, the number of merchants accepting these card brands in the UK is much smaller than for the two four-party card schemes and therefore these

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280 See, for example, Tirole, J (1988) *The Theory of Industrial Organisation*, sections 1.1.2 and 3.2.

281 See footnote 186.
cards may not be as substitutable for some cardholders.\textsuperscript{282} Nevertheless, the OFT does not believe that the appreciability of the restrictions identified in this Decision is affected by the inclusion of three-party schemes in the relevant market and has included all branded credit and charge card schemes in the relevant cardholder market.\textsuperscript{283}

\textit{MMF SSNIP test}

311. MMF has provided survey evidence that cardholders are sensitive to the level and existence of annual fees, transaction charges and interest rates.\textsuperscript{284} Oxera, on behalf of MMF, has estimated that, on the basis of the imposition of a transaction charge of 0.25 per cent, the elasticity of demand for credit and charge card usage is \(-/-<5\) and has relied on this estimate in its SSNIP test.\textsuperscript{285} This estimate was generated from a survey of cardholders. MMF has concluded on the basis of this SSNIP test that credit and charge cards are highly substitutable with alternative payment methods.

312. The OFT does not accept MMF’s conclusions and gives little weight to this evidence. First, there are inherent limitations in such survey evidence that may lead cardholders to overstate their response to hypothetical increases in charges.\textsuperscript{286} Secondly, the OFT does not believe that the approach used by MMF in generating the elasticity of cardholder demand is relevant to the hypothetical monopolist test, which is designed to establish whether a hypothetical monopolist could profitably exercise market power by raising prices above the competitive level. For a business such as credit card issuing, there are several elements of price. In order to establish that such a hypothetical monopolist credit card issuer would not possess market power, it is not sufficient to demonstrate that it would not be profitable to raise one particular element of price, as MMF has attempted to do. Instead, it would be necessary to demonstrate that there is not any feasible way in which prices can be profitably raised.

313. Currently, issuers do not levy transaction charges on cardholders.\textsuperscript{287} Expressed differently, issuers currently set the transaction charge at

\textsuperscript{282} The FACTS International Merchant Survey indicated that, of 1000 merchants accepting at least one brand of credit card, 31 per cent accepted Amex and 14 per cent Diners compared with 99 per cent acceptance for both Visa and MasterCard (see Table 7, FACTS International Merchant Survey).

\textsuperscript{283} See paragraphs 503-511 and 730 below.

\textsuperscript{284} Paragraph 3.2.6, Joint written representations on the SR14.

\textsuperscript{285} Page 36 at Annex 3, Joint written representations on the SR14.

\textsuperscript{286} See Annex 8 of this Decision. In addition, the OFT notes that in the decision of \textit{US v Visa USA, Visa International and MasterCard International}, 98 Civ 7076 (BSJ) October 9\textsuperscript{th} 2001 page 18, the United States District Court found, when specifically considering the response of cardholders to changes in elements of the price, that “it is essentially impossible to make a definitive calculation of consumer price sensitivity or elasticity of demand via survey.”

\textsuperscript{287} See page 13, PwC, \textit{Empirical evidence on the relevant market in which credit cards compete}, submitted as part of MCE/MCI Joint written representations to the R14 (23 January 2002).
Since issuers currently do not levy such a charge, it appears reasonable to infer that, given the other pricing options available, it is not profitable for them to do so. As a result, the OFT does not believe it is likely that a hypothetical profit-maximising monopolist credit and charge card issuer, when faced with alternative methods for raising prices to cardholders, would first choose to increase cardholder charges by means of a transaction charge. Therefore the OFT does not believe that Oxera’s estimates of the elasticity of demand based upon the imposition of such a charge are pertinent to an assessment of the relevant market.

**Cardholder sensitivity to interest rates**

Issuers charge interest to cardholders on outstanding balances and interest charges account for the largest source of issuer revenue. The OFT has assessed the effect of a hypothetical profit-maximising credit card issuer increasing interest rates on card balances. According to MMF, interest revenue accounts for between [between 50-60] per cent and [between 65-75] per cent of cardholder charges. Based upon data supplied to the OFT by a sample of MasterCard credit card issuers in July and August 2004, the OFT estimates that, on average between 2001 and 2003, interest charges accounted for [between 55-65] per cent of issuer revenue and [between 65-75] per cent of cardholder charges. By way of example, if the lower figure of 65 per cent were adopted, an increase in interest rate charges of 7.7 per cent would be required to increase the weighted average cardholder charge by 5 per cent.

The OFT has considered the available empirical evidence on the sensitivity of credit card demand to interest rates. A recent US study has estimated the responsiveness of consumers holding credit card debt to interest rates. This study examined cardholder account data and looked at actual consumer responses to changes in interest rates rather than survey data based upon surveyed cardholders’ responses to hypothetical price changes. The study looked at 24,000 credit card accounts over two years and found that the elasticity of aggregate credit card debt to interest rate changes is estimated to be -0.85. This implies that a 5 (or 10) per cent increase in interest rates would lead to a reduction in credit card balances of 4.25 (or 8.5) per cent respectively.

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288 When transaction value related cashback or rewards, such as airmiles, are offered by the issuer, the effective transaction charge to the cardholder is negative.

289 For the same reason, the OFT regards the unwillingness of cardholders to pay a transaction charge as evidence of the unwillingness of cardholders to be surcharged. Merchants do not generally surcharge for the same reason as issuers do not levy transaction charges, because of customer resistance (see paragraphs 262-291).


291 The effective interest rate in the UK on credit card balances was 14.55 per cent in June 2004. This implies that a 7.7 per cent increase in interest rate (a 5 per cent increase in weighted average price in this example) would involve a 112 basis point increase in the interest rate, from 14.55 per cent to 15.67 per cent. See Annex 2 of this Decision for details.

316. In addition to considering the effect of an increase in interest rates on balances and issuers' interest income, consideration must also be made of the effect on the value of transactions made using credit and charge cards and the transaction-related income. If interest rate increases reduce the value of transactions, then reductions in transaction-related income must be considered. The OFT does not consider that transactors would adjust their transaction behaviour in response to a change in interest rates since it is an element of price which they do not face. The proportion of transaction value that is non-revolving, and therefore does not attract interest, is [50-75]% per cent. Since the behaviour of most transactors will be unaffected by the increase in interest rates the OFT has considered the change in transaction volume from revolvers in response to an interest rate increase.

317. Revolvers may lower their balances in response to an interest rate increase by either paying off a greater proportion of the balances at the end of the month or lowering the value of transactions or a combination of the two. In the extreme a revolver may stop using his or her card completely in response to the interest rate increase. In Joint written representations on the SO, MMF has suggested that the elasticity of transaction value to an increase in interest rates is –[1-2].

318. In conducting a hypothetical monopolist test it is necessary to evaluate whether a particular price increase would be profitable or not. This evaluation can be effected using a critical sales loss analysis. The relevant critical sales loss analysis is considered in detail in Annex 2 (Hypothetical monopolist test in the issuing market) of this Decision. On the basis of this critical sales loss analysis the OFT concludes that a hypothetical monopolist credit and charge card issuer would find it profitable to increase price, via an increase in interest rates, by 5-10 per cent.

**MMF's response to the SO on the issuing market**

319. MMF has argued that in order to be consistent with the argument that MSCs are set above the competitive level and subject to the cellophane fallacy the OFT must address the alternative: if MSCs are too high compared to the competitive level then cardholder charges would be too low compared with their respective competitive levels. As a result a hypothetical monopolist test applied to cardholder charges would tend to result in too narrow a market.

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294 According to a survey commissioned by the OFT, 47 per cent of credit card cardholders may be classified as pure transactors, i.e. they pay the full balance every month, while a further 13 per cent of credit card cardholders are transactors most of the time but sometimes roll their balance over: Chart 4.6, OFT709 Credit Card Survey (March 2004).
295 Paragraph 59 at Annex 1, Joint written representations on the SO.
296 Paragraph 56 at Annex 1, Joint written representations on the SO.
The OFT's view

320. The hypothetical monopolist framework is based upon the assessment of substitution possibilities when prices are at the competitive level. The cellophane fallacy arises because prices have been set either collectively or individually at a level different to that which would prevail under competitive conditions. In such circumstances inferences based upon assessments of substitution at price level which is different from the competitive price level may be erroneous. As indicated below, this concern can apply equally whether the current price is above or below the competitive level.

321. For example, there are consumers who would, if the MMF MIF were set at the competitive level, use debit cards for transactions. If the MMF MIF is set above the competitive level and the revenue is used, in part, to fund cash back rewards or similar incentives to use credit cards, some of these consumers may be induced to use credit or charge cards for transactions rather than debit cards. In this case an increase in cardholder charges above a current ‘too low’ level towards the competitive level, may lead to those consumers switching back to debit cards. However since those consumers would not use credit cards if the MMF MIF were set at the competitive level, in principle, such switching is not relevant to the hypothetical monopolist test and examining such substitution could lead to the incorrect inference that credit and debit cards are in the same relevant market.297

322. Accordingly the OFT has conducted its evaluation carefully in the context of the agreement on the MMF MIF and is aware of the difficulties of conducting a hypothetical monopolist test in this context. Nevertheless it does not believe that its approach has led to the definition of too narrow a relevant market. In any event, the OFT notes that its conclusions on appreciability of the restrictions would be unaffected by the inclusion of debit cards in the relevant market.

The OFT's conclusion on the issuing market

323. The hypothetical increase in price considered in this instance by the OFT has taken the form of an increase in interest rates. The OFT reserves judgement over whether a hypothetical monopolist would actually increase price in this manner rather than through some other combination of price increases. The OFT believes, however, that the evidence demonstrates that there would be insufficient substitution on the part of cardholders to prevent a hypothetical monopolist credit card issuer from profitably raising prices via interest rates. There may be alternative combinations of price changes that lead to an overall increase in cardholder charges of 5-10 per cent that would be more profitable. However, in order to define the relevant market, it is necessary to consider the relevant constraints on the

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297 As is clear from this example, it is not necessarily the case that where the current price level is below the competitive level the relevant market will be narrowed erroneously by the cellophane fallacy: it can also be widened erroneously.
ability to exercise market power; it is not necessary to predict exactly how such a hypothetical monopolist may choose to use its market power.

324. The OFT believes that the evidence considered above demonstrates that market power could be exercised in this market by a hypothetical monopolist credit card issuer. Accordingly, the OFT does not consider it appropriate to widen the relevant market beyond the issuing of branded credit and charge cards.

325. For the avoidance of doubt, and notwithstanding the previous conclusion, the OFT does not dispute that some credit and charge card cardholders are sensitive to some elements that could make up the price of cardholding and that this sensitivity may lead those cardholders to substitute between alternative payment methods. Indeed, the OFT has accepted in paragraphs 311-313 that cardholders would be sensitive to transaction charges, and that a significant proportion of cardholders are unwilling to pay such charges.

326. In paragraphs 681-694, the OFT finds that the MMF MIF agreement restricts competition in issuing. In its representations MMF disputes this finding and argues that this finding is inconsistent with the definition of a relevant issuing market that is restricted to credit and charge cards (see paragraph 723 below).

327. The OFT does not believe that its conclusions on the relevant market for card issuing, its finding of a restriction in the issuing market and the belief that cardholders are sensitive to certain elements of price are inconsistent. First, cardholders display sensitivity to certain elements that could make up the price of cardholding, but do not display such sensitivity to others elements of issuer revenue such as MIF revenue, interest rates and late charges. The OFT believes that the recognition of the different sensitivity of cardholders to these elements of price is essential to an understanding of the effects of the agreement on the MMF MIF. Second, the magnitudes of the respective price changes differ according the question under consideration. In the framework of the hypothetical monopolist test, the relevant price change is 5-10 per cent above the competitive level. In the framework of considering the distortion to competition as a result of the recovery of 'extraneous costs' through the MMF MIF, the change in prices faced by cardholders may be greater than 5-10 per cent. Third, the market definition question considers not only price sensitivity but also critical loss. It is perfectly feasible for the critical loss to be such that the hypothetical monopolist increasing the price of credit and charge cards is profitable whilst there is still material substitution between payment mechanisms.

Supply-side substitution

328. Supply-side substitution may be relevant to market definition. If, in response to a price rise by incumbent firms, other firms which do not currently supply a product would supply that product at short notice (for

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298 See paragraphs 526 and 675-742 below.
example, within one year), this may constrain the ability of incumbents to increase prices. Supply-side substitutes will be included within the relevant market definition when it is clear to the OFT that substitution would take place quickly and easily. For example, if in response to a price rise by an association of issuers, a company or network of companies which did not currently provide network, transaction and payment guarantee services would supply those services at short notice, this may constrain the ability of the issuers to increase prices.

329. The OFT does not consider supply-side substitution to be feasible in any of the three markets considered here and so the relevant product markets are not widened beyond what the OFT has concluded above.

330. First, the vast majority of major banks are already members of the MasterCard or Visa card schemes and, therefore, already supply credit card transaction services, either as issuers or acquirers, or as both, for branded credit and charge cards.

331. Secondly, in any event, it would not be realistic for a new network of companies who are currently not offering Visa or MasterCard-branded services to enter the market in such a short time frame. Not only would these companies need to establish a strong and recognised brand and financial credibility quickly, but in order to be attractive to acquirers, merchants and cardholders, they would also need to match the ubiquitous and universal nature of the Visa and MasterCard schemes. This would require significant resources and related technologies. In this context, the OFT notes that the only new provider of a branded credit card product in recent years in the UK has been Amex, which is a three-party credit card scheme and which has failed to have a significant impact on the Visa and MasterCard schemes, despite having a recognised brand and already operating a charge card scheme.

332. For the reasons set out above, the OFT is not persuaded by MMF's representations that the provision of certain of the underlying components of payment systems by third parties is sufficient to broaden the relevant markets. In addition, the OFT has already explained in detail why other payment instruments do not form part of the relevant markets, even where such instruments are widely held and used (e.g. debit cards, cash and cheques). MMF's assertion that new forms of payment instrument form part of the relevant market are, therefore, unconvincing.

The Commission's treatment of product market definition in the Visa MIF decision

333. In the Visa MIF decision, the Commission concluded that it was not necessary to make any distinction between types of payment card in order to define the relevant product market and so the relevant inter-system

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299 Paragraph 3.13, OFT403 Market Definition (December 2004).
300 Over 677,000 outlets in the UK accept Visa or MasterCard credit cards (see page 13, KeyNote, Consumer Credit and Debt, Market Assessment Report (April 2005)).
market was considered as comprising all types of payment card.\textsuperscript{302} The relevant geographic market for assessing competitive issues relating to payment card schemes is mainly national. However, since Visa holds an important market position even on a world-wide market, the Commission left the precise geographic market position open.\textsuperscript{303}

334. MMF has argued that, under section 60 of the CA98, the OFT is bound to follow the market definition approach of the Commission as set out in its \textit{Notice on the application of EC rules to cross-border credit transfers},\textsuperscript{304} and in the Visa decisions. The OFT disagrees with MMF's submissions on this point.

335. As a general principle, whilst the OFT has duties under Article 10 of the EC Treaty, the Modernisation Regulation and section 60 of the CA98 to handle cases in a manner which is consistent with Community law, in considering market definition it has to apply economic analysis to the evidence, taking into account the factual circumstances of the UK market and reaching a conclusion that is the result of all of these factors.\textsuperscript{305} Moreover, it is a principle of EC law, established by the Court of First Instance, that the market must always be defined in any particular case by reference to the facts prevailing at the time and not solely by reference to precedents.\textsuperscript{306} This section of this Decision sets out the OFT's analysis which is based on the evidence before it, particularly as regards exiting and surcharging by merchants.

336. The OFT and the Commission have nevertheless come to similar findings on several key points in their respective market definition assessments.

337. First, the OFT and the Commission agree that a critical part of defining the relevant market is assessing the constraints exerted by inter-system competition on the MMF MIF agreement, which is made between intra-scheme competitors.\textsuperscript{307}

338. Second, the OFT and the Commission agree on the need to examine the reaction of merchants \textit{and} their cardholder customers in assessing the substitutability of different payment systems for the purpose of analysing inter-system competition, as their decisions are inter-related.\textsuperscript{308}

339. Third, the OFT and the Commission agree that the relevant markets should not be extended to include cash and cheques.\textsuperscript{309}

\textsuperscript{302} Paragraph 52, \textit{Visa MIF} decision.
\textsuperscript{303} Paragraph 53, \textit{Visa MIF} decision.
\textsuperscript{304} OJ [1995] C251/3.
\textsuperscript{305} See further paragraphs 94 and 107-116 above.
\textsuperscript{307} See paragraphs 43-46, \textit{Visa MIF} decision.
\textsuperscript{308} See paragraph 46, \textit{Visa MIF} decision and paragraphs 160-162 above.
\textsuperscript{309} See paragraphs 47-50, \textit{Visa MIF} decision and paragraphs 216-223 above.
340. Fourth, both the OFT and the Commission have come to the same key finding that the likely reaction of merchants to an increase in the MMF MIF and (consequently) MSCs will be to increase retail prices generally and that they will not exit the credit card schemes.\textsuperscript{310}

341. In carrying out its market definition analysis, the OFT has also considered the detailed evidence put to it by MMF as to whether merchants will surcharge their credit and charge card customers in the face of an increase in the MMF MIF and MSCs.\textsuperscript{311} The Commission did not consider this aspect, albeit that it has previously recognised that merchants rarely surcharge in practice.\textsuperscript{312}

342. Fifth, the OFT’s finding that the relevant product markets should not be extended to include debit cards is not inconsistent with the Commission’s decision in which it left this question open.\textsuperscript{313}

343. Finally, although the Commission left open the question of the definition of the relevant market for the purposes of the Visa MIF decision, it is implicit from its analysis of the restriction that, like the OFT, it has considered a market at the wholesale level between issuer and acquirers.\textsuperscript{314}

THE RELEVANT GEOGRAPHIC MARKET

344. In the notification, MMF identified the relevant geographic market as the whole of the UK.\textsuperscript{315} The OFT agrees with this view, which is consistent with that of the Commission in its Visa MIF decision. The Commission left the relevant geographic market open, whilst acknowledging that the market for payment card schemes is still mainly national.\textsuperscript{316}

THE OFT’S CONCLUSION ON MARKET DEFINITION

345. For the reasons set out above, for the purposes of this investigation the OFT has concluded that there are three relevant markets:

- the (wholesale) market for the provision of card transaction services between issuers and acquirers for purchases made by way of MasterCard branded consumer credit and charge cards in the UK;

- the (acquiring) market for the provision of merchant acquiring services by acquirers to merchants for purchases made by way of MasterCard branded consumer credit and charge cards in the UK; and

\textsuperscript{310} See paragraphs 48, 80 and footnote 39, Visa MIF decision and paragraph 301 above.
\textsuperscript{311} See paragraphs 262-280 above.
\textsuperscript{312} Paragraph 55, Case Comp/29.373 Visa International OJ [10.11.2001] L293/24.
\textsuperscript{313} Paragraph 52, Visa MIF decision and paragraphs 217-219 and 302-323 above.
\textsuperscript{314} However, even if debit cards were included in the relevant product markets this would not affect the OFT’s findings on appreciability - see paragraph 507 below.
\textsuperscript{315} Paragraphs 43, 64 and 67, Visa MIF decision.
\textsuperscript{316} Paragraph 6.1 of the notification.
• the (issuing) market for the provision of branded consumer credit and charge card issuing services by issuers to cardholders in the UK.
C  ARTICLE 81 AND THE CHAPTER I PROHIBITION

346. Article 81 prohibits agreements between undertakings, decisions by associations of undertakings and concerted practices which may appreciably affect trade between Member States and which have as their object or effect an appreciable prevention, restriction or distortion of competition within the common market, unless they fulfil the conditions of Article 81(3).

347. The Chapter I prohibition is contained in section 2(1) of the CA98. It provides that agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade within the UK and have as their object or effect the prevention, restriction or distortion of competition within the UK are prohibited unless they fulfil the conditions contained in section 9 of the CA98.

348. In this Decision "restriction of competition" and "distortion of competition" are used interchangeably and both should be read as meaning an appreciable prevention, restriction and/or distortion of competition in terms of Article 81(1) and the Chapter I prohibition. "Restricts competition" and "distorts competition" should be interpreted accordingly.

349. Article 3(1) of the Modernisation Regulation requires the OFT to apply Article 81 to agreements, decisions or concerted practices (within the meaning of Article 81(1)) where it applies national competition law to such agreements, decisions or concerted practices which may affect trade between Member States. The OFT therefore considers in this Decision whether the MMF MIF agreement may have an appreciable effect on trade between Member States within the meaning of Article 81(1).

STANDARD AND BURDEN OF PROOF

350. MMF has argued that any infringement decision must be based on “strong and compelling evidence” and that the OFT must demonstrate to this standard that the MMF MIF agreement is caught by Article 81(1) and the Chapter I prohibition. It states that the OFT has not provided evidence of this standard and has not demonstrated an infringement.318 This argument has also been made by other Parties.319

351. The case law of the CAT establishes that:320

(i) In relation to infringements of the Chapter I or Chapter II prohibitions, the applicable standard of proof is the civil standard (i.e. the balance of probabilities).

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318 Paragraphs 4.1–4.4, Joint written representations on the SO.
319 For example, see Mr Nigel Parr: page 7, Transcript of RBSG oral representations on the SR14 (22 May 2003).
An allegation of infringement is a serious matter which may involve penalties.

Where penalties are imposed under the CA98 the balance of probabilities standard is to be applied taking into account the gravity of what is alleged. The more serious the allegation, the more cogent should be the evidence before the court concludes that the allegation is established on the preponderance of probabilities.

On economic issues, this means that the CAT must be satisfied that the OFT’s analysis is robust and soundly based.

Whether evidence is likely to be sufficiently convincing to prove the infringement will depend on the circumstances and the facts.

The OFT does not intend to impose penalties in this case. Nevertheless, the OFT considers that its conclusion in this case that the MMF MIF agreement gives rise to two independent restrictions of competition is based on strong and compelling evidence, sufficient to overcome the presumption that the Parties have not engaged in unlawful conduct. This evidence is set out in detail in Sections D and E of this Decision.

The term ‘undertaking’ includes any natural or legal person engaged in economic activity, regardless of its legal status and the way in which it is financed. MMF and each of MMF’s members are undertakings within the meaning of Article 81 and the Chapter I prohibition. Hence, MMF is also an association of undertakings. The principal and affiliate licensees of MCE/MCI who are not members of MMF are also undertakings within the meaning of Article 81 and the Chapter I prohibition, as are MCE and MCI.

The UK Domestic Rules have been adopted by MMF’s members and the principal and affiliate licensees agree to be bound by the provisions contained in them. The UK Domestic Rules therefore constitute an agreement between undertakings and can also be characterised as a decision by an association of undertakings.

Effect on trade within the UK

The definition of 'domestic transactions' in clause 1.0 of the UK Domestic Rules is: “transactions that take place in the UK between a merchant and

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MMF’s members and the principal and affiliate licensees of MCE/MCI are listed in Annex 1 of this Decision.
a cardholder with a UK-issued card... A MasterCard card is issued in the UK if the BIN [bank identification number] on the card has been allocated to the issuer in respect of its licence to use the MasterCard trademark in the UK.” The term 'UK domestic transactions', which appears below, has a parallel meaning.

357. The UK Domestic Rules and, in particular, the MMF MIF agreement, govern the operating arrangements which apply in the UK to all domestic credit and charge card transactions which occur in the MasterCard scheme. Therefore, the UK Domestic Rules affect trade within the UK within the meaning of section 2 of the CA98.

Effect on trade between Member States

358. The Commission Guidelines on the effect on trade concept contained in Article 81 and 82 of the Treaty ('Guidelines on effect on trade') provide guidance on the application of the effect on trade concept.323 This is a jurisdictional criterion defining the scope of application of Community competition law324 and does not affect the substantive assessment of this case.

359. The Guidelines on effect on trade contain the following particularly relevant provisions (some of which are considered in further detail below) relating to when the effect on trade criterion will be satisfied in the case of Article 81:

(i) For Article 81 to be applicable there must be an influence on the "pattern of trade between Member States". The term 'pattern of trade' is neutral. It is not a condition that trade be restricted or reduced. Patterns of trade can also be affected when an agreement or practice causes an increase in trade. Indeed, Community law jurisdiction is established if trade between Member States is likely to develop differently with the agreement or practice compared to the way in which it would probably have developed in the absence of the agreement or practice.325

(ii) The function of the notion 'may affect' is to define the nature of the required impact on trade between Member States. According to the standard test developed by the European Court of Justice ('ECJ'), the notion 'may affect' implies that it must be possible to foresee with a sufficient degree of probability on the basis of a set of objective factors of law or fact that the agreement or practice may have an influence, direct or indirect, actual or potential, on the pattern of trade between Member States.326

324 Paragraph 12, Guidelines on effect on trade.
325 Paragraphs 33-34, Guidelines on effect on trade. See e.g. Case 71/74, Frubo v Commission, [1975] ECR 563, paragraph 38.
326 Paragraph 23, Guidelines on effect on trade. See e.g. Joined Cases T-25-104/95 and others, Cimenteries CBR SA, [2000] ECR II-491, paragraph 3930.
(iii) It is the agreement that must be capable of affecting trade between Member States. It is not required that each individual part of the agreement, including any restriction of competition which may flow from the agreement, is capable of doing so. If the agreement as a whole is capable of affecting trade between Member States, there is Community law jurisdiction in respect of the entire agreement, including any parts of the agreement that individually do not affect trade between Member States.327

(iv) The assessment under the effect on trade criterion depends on a number of factors that individually may not be decisive. The relevant factors include the nature of the agreement and practice, the nature of the products covered by the agreement or practice and the position and importance of the undertakings concerned.328

(v) The concept of 'trade' is not limited to traditional exchanges of goods and services across borders. It is a wider concept, covering all cross-border economic activity including establishment.329

(vi) The application of the effect on trade criterion is independent of the definition of geographic markets. Trade between Member States may be affected also in cases where the relevant market is national.330

360. In relation to effects on establishment, the ECJ and the Commission have paid regard to the extent of participation of the subsidiaries or branches of foreign undertakings in offering the service in question, as well as the extent to which the agreement in question may be a factor in the choice made by foreign undertakings as to whether or not to establish themselves in the Member State in question.331

361. Also, in its recent decision on Dutch Industrial and Medical Gases,332 the Commission took into account the fact that all the undertakings which took part in the infringements were part of multinational groups with facilities in several Member States. The multinational groups in question formed an economic unit, which meant that all changes in their competitive position in one Member State would have an effect on the position of the groups as a whole. The Commission decided that, purely in terms of financial flows within a group, improvements in the profitability

330 Paragraph 22, Guidelines on effect on trade.
331 See Bagnasco, supra, at paragraph 51; Dutch giro acceptance systems OJ [1999] L271/28.
of its Dutch branch are likely to affect trade because of changes in dividend payments or investment funds needed.

362. The OFT is satisfied that the MMF MIF agreement contained in the UK Domestic Rules has an appreciable effect on trade between Member States within the meaning of Article 81 for the following reasons.

363. First, as stated at paragraph 359 above, the requirement is that the agreement as a whole should be capable of affecting trade between Member States. It is not that any individual part of the agreement, including any restriction of competition which may flow from the agreement, must be capable of doing so. In this case, the agreement as a whole includes:

(i) all rules that apply to UK domestic transactions (as defined in the UK Domestic Rules);\(^{333}\)

(ii) the operating regulations found in the EPI (now MCE) Rules and the MCI Rules, incorporated where appropriate;\(^{334}\) and

(iii) the Memorandum and Articles of Association governing the existence and operation of MMF, including the criteria for membership thereof.\(^{335}\)

364. A transaction may qualify as a UK domestic transaction, even if:

(i) it involves an issuer licensed to operate in the UK, but having no substantive connection with the UK;\(^{336}\)

(ii) it involves an acquirer licensed to operate in the UK, but having no substantive connection with the UK;\(^{337}\)

(iii) it is a face-to-face transaction, involving a UK branch of a merchant incorporated and headquartered outside the UK;

(iv) it involves an 'international merchant' (as defined in the MCE Rules), and an acquirer not licensed to acquire in the UK, or having any substantive connection with the UK, but holding a central acquiring licence;\(^{338}\)

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\(^{333}\) See also page v of Europay’s Eurocard Rule Book (the ‘MCE Rules’), which states that reference should be made, without limitation, to a number of manuals, including the Europay Membership Rules (EMR). Finally, clause 15.04 of the MCI Bylaws and Rules (‘MCI Rules’) states that Europay (now MCE) has been delegated only certain of MCI’s rule-making powers for Europe, and that the extent of those delegations is as set out in the November 1996 MasterCard and Europay International Alliance Agreement (a copy of which has not been given to the OFT).

\(^{334}\) See paragraph 4.1.2.1 of the notification.

\(^{335}\) See paragraph 4.1 of the notification.

\(^{336}\) Article 1, sec. 1 and rule 7.04 of the MCI Rules.

\(^{337}\) Article 1, sec. 1 and rule 7.04 of the MCI Rules.

\(^{338}\) See rule 7.2 of the MCE Rules.
(v) it involves a cardholder who is a UK citizen, but habitually resident outside the UK (a member which has a licence to issue cards in the UK may actively promote and issue cards to UK citizens residing in countries in which that member is not licensed to issue, provided that such activity is directed only to such citizens); 339

(vi) it involves a cardholder who is neither a UK citizen, nor habitually resident in the UK (a member which has a licence to issue cards in the UK may issue cards to cardholders situated in countries other than the UK, provided that the issuer does not promote its MasterCard issuing programme in those other countries340); and

(vii) in the case of a remote transaction (e.g. internet, telephone or mail order), either the merchant or the cardholder is not situated in the UK.341

365. Therefore, the agreement as a whole affects inter-state trade because the UK domestic transactions that it covers may include transactions where one (or a number) of the parties to the transaction is situated outside the UK. In addition, because the rules applying to UK domestic transactions include rules about the terms to be included in agreements between merchants and acquirers,342 a transaction may qualify as a UK domestic transaction where an acquirer is based outside the UK and a merchant is based inside the UK, or vice versa.

366. Second, it should be observed that rule 8.2 of the EMR provides that:

“For those Members that are credit institutions a licence can be granted for any country in Europe where the Member has the right to carry on its activities in the field of payment systems. For Members that are owned directly or indirectly by credit institutions, a licence can only be granted for the country in which they are incorporated, or a country in which they are duly authorised and regulated by the competent authority(ies) who supervise credit institutions in that country.”

367. Under rule 3.1 of the EMR only credit institutions and entities owned by credit institutions are eligible for membership of MCE.

368. Rules 8.2 and 3.1, in concert, limit scope for involvement of non-UK based MCE members in UK domestic transactions, and are capable of having an effect on inter-state trade.

369. Third, the MMF MIF agreement in particular (as a component of the overall agreement) is capable of affecting trade between Member States because it is likely to result in increased supply of MasterCard credit and charge cards and decreasing use of other payment methods such as debit cards,

339 See rule 7.04(c)(ii) of the MCI Rules.
340 See rule 7.04(c)(i) of the MCI Rules.
341 See rule 8.4 of the EMR.
342 See, e.g. rule 9.04 of the MCI Rules.
which are or may be offered by branches or subsidiaries of banks based in other Member States.\textsuperscript{343}

370. Similarly, the MMF MIF agreement influences the terms of competition between issuing banks for cardholder business, including in particular issuing banks that are branches or subsidiaries of banks based in other Member States.\textsuperscript{344} The MMF MIF agreement covers elements such as the cost of the interest-free period that are otherwise likely to be the subject of greater competition between issuing banks in relation to cardholders, and altering the pattern of trade.

371. For the reasons set out above, the OFT considers that the MMF MIF agreement has an appreciable effect on trade between Member States within the meaning of Article 81.

OBSERVATIONS ON THE ECONOMICS OF FOUR-PARTY PAYMENT CARD SCHEMES

372. Before considering the specific case of the MMF MIF agreement, it is helpful to consider briefly some observations on the economic analysis of interchange fees for payment cards in general. The economic literature on interchange fees is not specific to credit cards - the same principles are applied to debit cards.

373. In a four-party payment card network, acquirers supply services to merchants and issuers supply services to cardholders. In order for cardholders and merchants successfully to complete transactions, acquirers and issuers must also exchange information and funds. In the absence of an interchange fee, or with a fee set at zero, acquirers would recover the costs they incur in providing the payment mechanism to merchants and issuers would recover the costs they incur in providing the payment mechanism from cardholders. Competition between acquirers within the scheme would be expected to push merchant fees, in the form of an MSC, down towards acquirers’ costs.

374. When deciding whether to hold or use the cards of any four-party payment card scheme, cardholders will make individual decisions which may be privately optimal for them but socially inefficient because they do not consider the benefits and costs to others. Similarly, merchants may make privately optimal but socially inefficient decisions about whether to accept the scheme’s cards. There can be network externalities between cardholders and merchants.

375. An interchange fee, which enables acquirers to reimburse issuers for services that they provide or vice versa, can alter the balance between card acceptance and holding/usage. In the presence of network externalities (i.e. network effects that have not been internalised), there is no presumption that the level of an interchange fee that internalises these externalities is zero. But since network externalities can in principle go

\textsuperscript{343} See paragraphs 689-694 below.

\textsuperscript{344} E.g. Bank of Ireland, Banque Invik SA and ABN Amro Bank NV.
either way, neither is there a general presumption as to the desirable direction of rebalancing, relative to an interchange fee of zero.

376. As to the desirability of using the interchange fee to tune the balance between card acceptance and card holding/usage, it may well be that the case is stronger in nascent systems than in mature systems with wide coverage. In mature systems there is unlikely to be a problem of viability, and any network externalities resulting from changes in membership on either side of the market may be small relative to those in a nascent system. It is in mature systems with wide coverage that retailers may feel most obliged to accept the cards of those systems.

377. Particularly in mature systems, there is an important discrepancy between the private benefits of card acceptance to individual merchants and any benefits to merchants in aggregate. This discrepancy arises because a merchant’s decision to accept a scheme’s card is driven by the knowledge that the merchant can increase its own sales by taking sales from other merchants. In other words, in a context where acceptance of a scheme’s card is widespread, in making the decision not to accept a card, a merchant would expect to lose sales from cardholders who have a preference for using that card. In the UK, merchants accept both Visa and MasterCard cards. Therefore, the practical choice faced by merchants is whether to accept both types of card (accounting for the major segment of four-party payment cards): the question is not simply whether to accept MasterCard cards. The consequence of this is that an individual merchant’s willingness to pay to accept a card is greater than the net benefit to all merchants from that merchant accepting a card.

378. Therefore, the sum of individual merchant benefits from card acceptance will be greater than the total benefits to merchants and the willingness to pay of an individual merchant is not an adequate guide to merchant benefits. A further consequence of this is that MSCs, which are set according to the individual willingness to pay of merchants, are likely to be set at an inefficiently high level. Furthermore, as long as issuers are not perfectly competitive, issuers can expect to increase their profits through such an increase in interchange fees.

379. The extent to which merchant acceptance of cards can be taken to represent overall merchant benefit is further complicated by the incentives of cardholders, determined by the cost/reward structures that they face. If the interchange fee is set at an amount which allows issuers to provide cardholders with rewards for holding and using a scheme’s card (e.g. air miles or cash-back rewards), a cardholder will be even more disappointed if a merchant does not accept that card (and, therefore, more likely to switch to a competing merchant that does accept them) because they lose any reward as well as the ability to use this payment method. This will increase the incentive of an individual merchant to accept the scheme’s cards without any necessary contribution to the benefit of merchants in aggregate.

380. So there are at least two likely causes of divergence of the private benefits and the wider benefits to other members of the scheme and
society as a whole – network externalities between cardholders and merchants and the ‘merchant rivalry’ externality relating to merchants. The effect of each of these is different. On the one hand, the network externalities suggest that there should be no presumption that interchange fees should be zero. Indeed, interchange fees may be positive or negative. On the other hand, the merchant rivalry externality means that, if set at a level to extract the maximum that merchants are willing to pay, the interchange fee can be set at a level that is inefficiently high. Such over-recovery of revenue from merchants can create knock-on effects.

381. Unless merchants impose a surcharge on purchases made using the card, they must account for an MSC in setting their retail prices. The interchange fee is therefore important because it directly affects the amount of MSCs and, in turn, impacts on retail prices generally. In the absence of widespread surcharging, an increase in the interchange fee will increase merchants’ costs and tend to increase retail prices for all customers, irrespective of whether they make a purchase using a scheme card. Customers who pay using a scheme card may recoup some of the increased retail prices arising from an increased interchange fee via rebates or lower card transaction charges, but other customers will not.

382. The incentive for consumers to hold and use a scheme card, relative to other payment methods, will also shift with the interchange fee in the absence of surcharging. An unduly high interchange fee for a particular card scheme could substantially distort consumer choice between payment methods, with important consequences for economic efficiency, and to the particular detriment of merchants and consumers who do not generally pay by that card.\(^{345}\)

383. Having made these general observations, we now turn to consider the specific restrictions contained in the MMF MIF agreement.

**SUMMARY OF THE OFT’S FINDINGS ON THE APPLICATION OF ARTICLE 81(1) AND THE CHAPTER I PROHIBITION**

384. The OFT considers that the MMF MIF agreement gives rise to two restrictions of competition: the ‘collective price restriction’ and the ‘extraneous costs restriction’. The collective price restriction and the extraneous costs restriction are independent restrictions and have been established by the OFT on the basis of separate analysis. The OFT considers that both restrictions are established in this Decision. Even if this were not so, the MMF MIF agreement is caught by Article 81(1) and the Chapter I prohibition if either one of the restrictions is established.

385. The OFT finds that the MMF MIF agreement gives rise to the collective price restriction because it contains a collective agreement on the amount of the MMF MIF applying to almost all domestic transactions over the

\(^{345}\) For the purposes of assessing detriments arising from the MMF MIF agreement, the OFT considers that merchants are consumers (see paragraph 651 below). Detriment to merchants will arise in the event that higher MSCs generated by a higher MMF MIF (see paragraphs 681-694 below) cannot be fully passed on to their customers.
period to which this Decision relates and therefore restricts competition. The OFT finds separately that, insofar as the amount of the MMF MIF exceeds the level of payment transmission costs incurred by issuers\textsuperscript{346} (i.e. because it is set by reference to extraneous costs\textsuperscript{347} and used as a vehicle for recovery of these costs), the MMF MIF agreement gives rise to the extraneous costs restriction. This restriction arises from the operation of the MMF MIF as a mechanism which enables issuers to pass on and recover extraneous costs from acquirers (and, ultimately, from merchants and merchants’ customers).

386. In making both findings, the OFT has considered all of the representations and submissions it has received in the course of the administrative procedure preceding this Decision.

387. The OFT’s analysis of the collective price restriction and the extraneous costs restriction is set out in detail below in Sections D and E respectively of this Decision.

\textsuperscript{346} See paragraph 526 below.
\textsuperscript{347} See paragraph 526 below.
D THE COLLECTIVE PRICE RESTRICTION

388. In this Section of this Decision, the OFT examines:

- the object of the collective price restriction arising from the MMF MIF agreement in terms of Article 81(1) and the Chapter I prohibition;
- the effect of the collective price restriction arising from the MMF MIF agreement in terms of Article 81(1) and the Chapter I prohibition;
- whether the collective price restriction gives rise to an appreciable restriction of competition in terms of Article 81(1) and the Chapter I prohibition;
- arguments made by the Parties and other persons concerning the OFT’s assessment of the impact on competition of this restriction; and
- whether the collective price restriction satisfies each of the exemption conditions contained in Article 81(3) and section 9 of the CA98.

OBJECT OF THE COLLECTIVE PRICE RESTRICTION

389. The UK Domestic Rules allow the Parties to enter bilateral agreements if they wish to. Such agreements could set a bilateral interchange fee which differs from the MMF MIF. However, the MMF MIF agreement operates as the de facto interchange fee paid by the Parties. In practice, because of the existence of the MMF MIF, the Parties typically do not enter bilateral agreements to determine the amount of the interchange fee applicable to transactions between individual issuer and acquirer pairs, and the mechanism for arbitration by MCE provided for in the UK Domestic Rules is not used.

390. Although it has not made this finding, the OFT considers that the MMF MIF agreement could be characterised as a price-fixing agreement which has as its object the restriction of competition in the wholesale and acquiring markets. This characterisation is possible because the collective price restriction, in practice, results in a collectively agreed interchange fee (i.e. the MMF MIF) which issuers charge acquirers. In practice, therefore, the Parties are not determining independently their own pricing policies vis-à-vis each other. The freedom to determine independently one’s own pricing policies can be regarded as the “essence of the competitive process”. Accordingly, the MMF MIF agreement could be characterised as an “obvious restriction of competition.”

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348 See paragraph 40 above.
349 See paragraphs 42-43 above.
350 See Rule 4.6 and 4.6.1, UK Domestic Rules.
391. In addition, the economic context in which the MMF MIF agreement operates means that the MMF MIF acts as a common price floor for the MSCs paid by merchants to acquirers. Therefore, if the MMF MIF agreement has as its object the restriction of competition in the wholesale market, it also has as its object the restriction of competition in the acquiring market.

392. However, because the OFT finds that the MMF MIF agreement has the effect of restricting competition, it is not necessary to conclude on whether it also has the object of restricting competition for the purposes of Article 81(1) and the Chapter I prohibition.

393. As the OFT has not made any definitive finding as to whether the MMF MIF agreement has the object of restricting competition, there is no foundation for the argument made by Visa that the OFT's findings in relation to the object of the MMF MIF agreement are inconsistent with the Commission's conclusion in the Visa MIF decision.

EFFECT OF THE COLLECTIVE PRICE RESTRICTION

394. The effect on competition of the collective price restriction is assessed below. In assessing the effect on competition of the collective price restriction resulting from the MMF MIF agreement, the OFT has considered the likely impact of the restriction on actual or potential competition against competition which would be likely in the counterfactual situation without the restriction. The approach adopted by the OFT in assessing the collective price restriction is consistent with that described in paragraphs 17 to 27 of the Commission's Notice, Guidelines on the application of Article 81(3) of the Treaty ('the Article 81(3) Notice').

Restriction in the wholesale market

395. The MMF MIF agreement provides a fallback mechanism in the form of the MMF MIF. In the absence of an interchange fee set by bilateral agreement or arbitration, the MMF MIF applies as a default interchange fee in any transaction between issuers and acquirers. In practice, the OFT finds that the MMF MIF agreement results in the Parties (as undertakings in actual or potential competition) collectively agreeing on (i) the services in respect of which costs should be recovered through the MMF MIF (ultimately determining who bears these costs) and thereby (ii) the interchange fee applying to almost all transactions involving MasterCard cards over the period to which this Decision relates.

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354 See further paragraph 413 below.
357 See paragraphs 413-414 below.
358 In response to the OFT information request under section 26 of the CA98, MasterCard acquirers have reported to the OFT in July and August 2004 that they have no bilateral arrangements in place. Between 1997 and 1999, less than 1 per cent of
396. The OFT considers that the collective price restriction gives rise to a restriction of competition in the wholesale market because it deters Parties from entering bilateral agreements. The OFT notes the Commission’s finding in *Reims II*\(^{359}\) in relation to the dissuasive effect which a fallback mechanism has on the conclusion of bilateral agreements. Indeed, this effect is evident in this case, in view of the fact that at the end of the period to which this Decision relates no bilateral agreements existed. Effectively, issuers are dissuaded from developing an individual pricing policy in relation to the wholesale services they provide (as issuers) to acquirers, as found by the Commission in the *Visa MIF* decision.\(^{360}\)

**Deterring bilateral agreements and preventing individual pricing policy**

397. The existence of the MMF MIF means there is very little incentive for the Parties to enter into bilateral agreements in which the amount of the applicable interchange fee differs from the MMF MIF or is set by reference to categories of costs which are different from those taken into account in setting the MMF MIF. Net issuers have little incentive to negotiate a reduced MIF because the MMF MIF constitutes a revenue stream for them. Equally, acquirers have little incentive to negotiate a reduced MIF because:

(i) they can pass on the MMF MIF to merchants as part of the MSC they charge to merchants, and the ability of merchants to reduce an MSC is limited;

(ii) they know that every other acquirer transacts on the basis of the same MIF and uses this as a price floor for its MSC; and

(iii) almost all acquirers are issuers, although not all are net issuers, and as issuers they will be reimbursed by other acquirers for the MMF MIF either fully or in part.

398. Without the MMF MIF agreement, individual issuers and acquirers would have more incentive to seek interchange fees that maximise their private benefit (i.e. higher for issuers and lower for acquirers) and which reflect the individual features of their businesses. In these circumstances, they would be likely to enter bilateral agreements in which the amount of the applicable interchange fee differs from the amount of the MMF MIF. Where a bilateral agreement could not be concluded, any interchange fee could be determined by arbitration (rather than being set through collective agreement).

399. The OFT considers that a four-party payment card scheme in which interchange fees are set by bilateral agreements between issuers and acquirers, with arbitration as fallback mechanism, would be viable in the UK for the following reasons.

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\(^{360}\) See paragraph 67, *Visa MIF* decision.
First, the OFT notes that the UK Domestic Rules suggest that bilateral agreements on interchange fees can be entered into in the presence of an honour all cards rule, which requires a merchant who agrees to accept MasterCard cards to accept all cards of this brand (see paragraph 11 above). Rule 4.6 of the UK Domestic Rules provides that “the scheme encourages members to make reasonable endeavours to agree commercially driven bilateral interchange fees, but in the absence of a Bilateral Interchange Agreement, Domestic Fallback Interchange Fees will apply.” This provision in the UK Domestic Rules for issuers and acquirers to enter bilateral agreements shows that the Parties accept the possibility that the MasterCard scheme could function in circumstances where interchange fees are determined by bilateral agreement rather than the MMF MIF agreement.

Second, the OFT notes that the Australian EFTPOS\textsuperscript{361} debit card system in which all interchange fees are determined by bilateral agreement, and paid by issuers to acquirers, operates as a stable, effective payment transmission mechanism. Although the EFTPOS system does not have an honour all cards rule, in practice there is universal acceptance of EFTPOS cards at a large number of merchants throughout the country.

Third, the OFT notes that in Sweden the Visa and MasterCard schemes’ interchange fees for domestic transactions are normally determined by bilateral agreement between issuers and acquirers.\textsuperscript{362} These schemes operate with an honour all cards rule. If two banks are unable to agree an interchange rate, arbitration at MasterCard International or Visa International is required. The European intra-regional MIF operates as a default interchange fee pending arbitration. Where banks cannot agree the amount of an interchange fee bilaterally, the European intra-regional MIF will apply unless and until replaced by an interchange fee set by arbitration (or, alternatively, a later bilateral agreement). MMF has stated that it understands that arbitration has never taken place in Sweden, although a minority of the bilateral agreements in the Swedish MasterCard scheme (\(10\)\% agreements of \(<40\)\%\) have been agreed at the level of the European intra-regional MIF. However, the Swedish Visa and MasterCard schemes are nevertheless established on the basis that issuers and acquirers will conclude bilateral agreements and in practice these agreements yield interchange fees that do differ from the intra-regional MIF.\textsuperscript{363}

The use of the European intra-regional MIF in the Swedish MasterCard scheme does mean that it operates differently from a scheme based on bilateral agreements with no default interchange fee pending arbitration.\textsuperscript{364} Under the latter, an interchange fee would apply to transactions only if

\textsuperscript{361} Electronic Funds Transfer at Point of Sale.

\textsuperscript{362} Page 28, Retail Banking Research, ’Payment Cards in Europe 2004’, Sweden.

\textsuperscript{363} Letter from MCE to Service de la concurrence, Belgium (24 June 2005). Information contained in this letter was collected by the Service de la concurrence and transmitted to the OFT pursuant to Article 22 of Regulation 1/2003.

\textsuperscript{364} Mr Carl Munson: page 89, Transcript of joint oral representations on the SO.
issuers and acquirers had entered a bilateral agreement or accepted an arbitrator’s determination. However, in a scheme based on bilateral agreements, the OFT does not consider it necessary to have a MIF pending the outcome of arbitration. New entrants to the MasterCard scheme could either:

(i) begin dealing pending arbitration (with a subsequent ’reckoning up’); or

(ii) delay dealing until arbitration had been completed.

404. The operation of the intra-regional MIF in the Swedish MasterCard scheme does differ materially from the operation of the MMF MIF, which applies in practice to all UK domestic transactions, in the sense that the European intra-regional MIF applies as a default only where negotiating a bilateral agreement has failed and arbitration has not taken place. It does not operate as a default interchange fee in other circumstances.\(^{365}\)

405. A consequence of the difference in operation between the Swedish MasterCard scheme and the UK MasterCard scheme is seen in the fact that in the Swedish MasterCard scheme, in \(>20\) out of \(<40\) bilateral agreements the applicable interchange fee differs from the European intra-regional MIF.\(^{366}\) In the Swedish MasterCard scheme in 2003, approximately \(>90\) per cent of transactions by Euro volume (i.e. value) were subject to bilaterally negotiated interchanges fees which differed from the European intra-regional MIF (equating to approximately \(>90\) per cent by number of domestic transactions).\(^{367}\)

406. Although fewer issuers and acquirers participate in the Swedish scheme relative to the UK scheme, the OFT notes that if MasterCard scheme interchange fees in the UK were set by bilateral agreements, this would require each issuer to enter at most 12 agreements and each acquirer to enter approximately 50 agreements with issuers. The OFT considers that it would not be impracticable for issuers and acquirers to conclude such a number of bilateral agreements, and that the higher number of issuers and acquirers participating in the MasterCard scheme does not affect the ability of interchange fees to be set in this way. Indeed, the commercial realism of this counterfactual is indicated by the extent to which the major issuers and acquirers (i.e. major banks) already negotiate agreements on complex matters, such as agreements on payment clearing processes, and the fact that all acquirers already negotiate agreements with merchants on MSCs which involve substantially the same considerations as would negotiation of bilateral agreements setting interchange fees.\(^{368}\)

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365 The OFT does not consider that the operation of a default interchange fee pending arbitration is necessary in a scheme based on bilateral agreements (see paragraphs 398-407 above).

366 Mr Tom Sharpe QC: page 88, Transcript of joint oral representations on the SO.

367 Letter from MCE to Service de la concurrence, Belgium (24 June 2005).

368 See paragraph 445 below.
From the UK Domestic Rules, the Swedish Visa and MasterCard schemes, and the Australian EFTPOS system, the OFT draws the conclusions that:

(i) there is potential for issuers and acquirers participating in four-party payment card schemes to set interchange fees by bilateral agreement;

(ii) four-party payment card schemes in which interchange fees are set by bilateral agreements can remain stable (i.e. will not collapse);

(iii) transactions between issuers and acquirers are apparently satisfactorily completed in such schemes; and

(iv) (as shown by the Swedish Visa and MasterCard schemes) a four-party payment card scheme in which interchange fees are set by bilateral agreements is compatible with the existence of an honour all cards rule.

A four-party payment card scheme in which interchange fees are set by bilateral agreements between issuers and acquirers, with arbitration as a fallback mechanism, is likely to yield interchange fees which vary between each bilateral agreement (as, indeed, is the case in Sweden). At the very least, such a scheme would provide additional incentives to negotiate interchange fees which vary from the MMF MIF and scope for competition in the form of increased efficiencies, which could be passed on to consumers. For example, an acquirer who developed effective procedures for preventing fraud at its merchants would present a lower risk to issuers. In a competitive environment, such an acquirer would normally expect to benefit from this efficiency by being able to negotiate lower interchange fees. In a scheme where interchange fees are set by bilateral agreements (with arbitration as a fallback mechanism and with no MIF pending arbitration), efficiency considerations would likely be relevant both in the negotiation of a bilateral agreement and in any arbitration thus providing an incentive for issuers and acquirers to enter bilateral agreements that take such factors into account.

As explained above, incentives to seek benefit from efficiencies and determine an individual pricing policy are muted due to the existence of the MMF MIF. Therefore, the incentive for acquirers to compete by introducing, for example, fraud prevention measures is similarly reduced.

The OFT acknowledges that the operation of the honour all cards rule alone, in the absence of a MIF, alters the relative bargaining power of issuers and acquirers in concluding bilateral agreements in the case of new entry by either. For example, an issuer may hold out for a better deal from a new entrant acquirer using the threat of arbitration, which might delay entry and impose costs on the new entrant, as a way of extracting a higher interchange fee. This impact of the honour all cards rule on relative bargaining power might reduce the extent to which issuers would be willing to offer more attractive terms (i.e. reduced interchange fees) to

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369 The only special business category of MMF MIF is that for [REDACTED].
acquirers in bilateral agreements. However, on its own it would not restrict competition to the same extent as the MMF MIF agreement does because it would not result in an interchange fee arising from collective agreement between issuers and new entrant acquirers.

**Restriction in the acquiring market**

411. The OFT also considers that the collective price restriction gives rise to a restriction of competition in the acquiring market for the purposes of Article 81(1) and the Chapter I prohibition by restricting competition between acquirers for merchants.

412. The MMF MIF is a cost for acquirers proportionate to the monetary value of transactions processed. This cost represents a major part of acquirers’ total costs and is passed on in an MSC which acquirers charge to merchants. The OFT understands that the average proportion of MSCs accounted for by the MMF MIF is 80 per cent, although the actual proportion will vary across merchants depending, in particular, on their ability to negotiate down the level of an MSC.\(^{370}\)

413. All major acquirers participating in the MasterCard scheme are involved in the setting of the amount of the MMF MIF through membership of MMF, and agree the amount of the common price floor they all face. Moreover, an acquirer has no incentive to set an MSC lower than the level of the MMF MIF, since to do so would require the acquirer to absorb part of the costs of the MMF MIF as well as make a loss on its acquiring activity.\(^{371}\)

414. The MMF MIF agreement has a direct effect on the MSCs paid by merchants to acquirers because the MMF MIF operates as a common price floor for the MSCs charged by acquirers to merchants. This common price floor will not necessarily reflect the features of the business of individual acquirers. Some individual acquirers may operate more efficiently than acquirers in general. In addition, as noted above, some individual acquirers may present a lower risk to issuers than acquirers in general. Nevertheless, all acquirers face the same interchange fee (i.e. the MMF MIF) as a common cost irrespective of their relative efficiency and the level of risk attached to transactions which they acquire. In addition, as a common price floor the MMF MIF restricts the scope for intra-scheme competition between acquirers on the MSCs paid by merchants.

**Restriction in the issuing market**

415. Lastly, the OFT considers that the collective price restriction is likely to distort competition in the issuing market by indirectly influencing which card brands (e.g. MasterCard vs Visa) and which card types (e.g. credit

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\(^{370}\) See paragraph 9 and footnote 13 above.

\(^{371}\) For example, while use of an average unit cost to set the MMF MIF can provide an incentive for issuers to reduce costs below the average (see paragraph 655 below) acquirers pay the same MIF regardless of the costs that the merchants they acquire impose on the system. Therefore, this reduces the incentives of acquires to compete for merchants who, for example, may present a lower fraud risk.
card vs debit card) issuers offer and promote to their customers. However, the OFT does not rely on the likelihood of this distortion of competition in the issuing markets in making any of its findings on the collective price restriction.\footnote{Effects on competition in issuing are considered in paragraphs 689-694 below.}

**REPRESENTATIONS AND SUBMISSIONS ON COLLECTIVE PRICE RESTRICTION IN THE WHOLESALE MARKET**

416. In this part of the Decision, the OFT summarises the main arguments made against its finding that the collective price restriction gives rise to a restriction of competition in the wholesale market for the purposes of Article 81(1) and the Chapter I prohibition. These arguments are contained in representations made by, and on behalf of, the Parties and submissions made by other persons.

**Restrictions have not been considered in the correct legal framework**

**Summary of arguments made**

417. MMF argues that, to assess correctly whether a restriction of competition exists, the OFT must:\footnote{Paragraphs 4.12-4.25, Joint written representations on the SO.}

> “...consider the actual effects of the agreement as compared with competition that would exist in its absence (ie it must consider the effects of the agreement against the correct counterfactual); and must consider whether any potentially restrictive effects are necessary for the implementation of legitimate aims (ie that without the restriction the objective could only be implemented under more uncertain conditions, or at substantially higher cost, or over an appreciably longer period, or with considerably less prospect of success).” \footnote{Paragraph 4.24, Joint written representations on the SO.}

418. According to MMF, a restriction is not caught by Article 81(1) or the Chapter I prohibition if it is objectively necessary to the functioning of a legitimate operation. In assessing whether a restriction contained in the MMF MIF agreement is a restriction of competition, the OFT must consider whether it is necessary to the proper functioning of the MasterCard scheme with all its benefits and ubiquity (rather than to the proper functioning of any other scheme).

419. MMF states that this approach to assessing a restriction does not require the OFT to conduct a “rule of reason” analysis or to weigh up the pro-competitive and anti-competitive effects of the MMF MIF agreement to determine whether it is caught by Article 81(1) or the Chapter I prohibition. Therefore, the OFT is wrong to assert that MMF’s proposed approach is inconsistent with *Métropole Télévision and others v Commission* (*Méropole*)\footnote{Case T-112/99 [2001] ECR II-2459.} *Méropole* does not qualify the principle that competition must be assessed in the actual context in which it would...
occur absent the potential restriction. The CFI’s finding in *Métropole* did not qualify the findings of the ECJ in *Gøttrup Klim* *Grovvareforening v Dansk Landbrugs Grovvareselskab AmbA (DLG) (‘Gøttrup Klim’)*\(^\text{376}\) that a restriction must be assessed by reference to its effects in the actual context in which it operates.\(^\text{377}\)

420. The ECJ’s decision in *Wouters v Algemene Raad van de Nederlandse Orde van Advocaten*\(^\text{378}\) (‘Wouters’), the application of which MMF considers is not limited to circumstances involving “*regulatory rules*”, does not affect the principle that a restriction is lawful if objectively necessary to the functioning of a legitimate operation.\(^\text{379}\)

**The OFT’s response**

421. The OFT does not accept MMF’s argument that what is relevant in determining whether a restriction contained in the MMF MIF agreement amounts to a restriction of competition is whether it is objectively necessary to the functioning of the MasterCard scheme “*with all its benefits and ubiquity*” (i.e. to implement a four-party payment card scheme with all features of the MasterCard scheme). Rather, it considers that the restriction is integral only if it is necessary to implement a viable four-party payment card scheme.

422. In essence, MMF’s argument invites the OFT to weigh the pro-competitive and anti-competitive effects of the MMF MIF agreement in determining whether a restriction of competition exists. This approach to assessing a restriction would require the OFT to compare, on the one hand, the state of competition with the restriction and, on the other hand, the state of competition in a hypothetical situation without the restriction and without the claimed benefits arising from the restriction. It would be incorrect to weigh the pro-competitive and anti-competitive effects of the MMF MIF agreement in deciding whether the restrictions contained in this agreement are caught by Article 81(1) and the Chapter I prohibition. This analysis can only occur when applying the exemption criteria in Article 81(3) and/or section 9 of the CA98.\(^\text{380}\)

423. Taking arguments made on the basis of *Gøttrup Klim* first, the ECJ found in the key part of its judgment that:

> “30 A cooperative purchasing association is a voluntary association of persons established in order to pursue common commercial objectives.

> 31 The compatibility of the statutes of such an association with the Community rules on competition cannot be assessed in the abstract. It will

\(^{377}\) Paragraphs 4.13 – 4.18, Joint written representations on the SO.  
\(^{379}\) Paragraphs 4.19 – 4.23, Joint written representations on the SO.  
\(^{380}\) See *Métropole*. See also the judgment of the CCAT, pre-dating *Métropole*, in *Institute of Independent Insurance Brokers and Association of British Travel Agents v Director General of Fair Trading* [2001] CAT 4 at [214] to [217], particularly.
depend on the particular clauses in the statutes and the economic conditions prevailing on the markets concerned.

32 In a market where product prices vary according to the volume of orders, the activities of cooperative purchasing associations may, depending on the size of their membership, constitute a significant counterweight to the contractual power of large producers and make way for more effective competition.

33 Where some members of two competing cooperative purchasing associations belong to both at the same time, the result is to make each association less capable of pursuing its objectives for the benefit of the rest of its members, especially where the members concerned, as in the case in point, are themselves cooperative associations with a large number of individual members.

34 It follows that such dual membership would jeopardize both the proper functioning of the cooperative and its contractual power in relation to producers. Prohibition of dual membership does not, therefore, necessarily constitute a restriction of competition within the meaning of Article [81(1)] of the Treaty and may even have beneficial effects on competition.

35 Nevertheless, a provision in the statutes of a cooperative purchasing association, restricting the opportunity for members to join other types of competing cooperatives and thus discouraging them from obtaining supplies elsewhere, may have adverse effects on competition. So, in order to escape the prohibition laid down in Article [81(1)] of the Treaty, the restrictions imposed on members by the statutes of cooperative purchasing associations must be limited to what is necessary to ensure that the cooperative functions properly and maintains its contractual power in relation to producers."

(emphases added)

424. The OFT does not accept Gøttrup-Klim as a basis for finding that the MMF MIF agreement is not restrictive of competition for the purposes of Article 81(1) and the Chapter I prohibition. By reference to the words emphasised in paragraph 35 from the judgment quoted above, it is not the case that a four-party payment card scheme could not function properly without a MIF such as the MMF MIF. As noted above in paragraphs 401-408, the Swedish MasterCard and Visa schemes and the Australian EFTPOS system are examples of four-party payment card schemes that do operate successfully on the basis of bilaterally negotiated interchange fees, rather than a (collectively agreed) interchange fee.

425. In addition, and in any event, even if it were the case, as the Parties' claim, that Gøttrup Klim was authority for the proposition that, in assessing whether a restriction contained in the MMF MIF agreement is a restriction of competition, the OFT must consider whether it is necessary to the proper functioning of the MasterCard scheme with all its benefits and ubiquity, the ECJ's judgment was expressed to apply only to the
specific circumstances of a co-operative purchasing association.\textsuperscript{381} It would not be correct to apply such an approach in the context of the MasterCard scheme.

426. As regards reliance on the general principle that the Parties claim can be derived from \textit{Wouters} – that a restriction is lawful if objectively necessary to the functioning of a legitimate operation – the OFT considers that, in relation to the MasterCard scheme, “\textit{legitimate operation}” means the operation of a viable four-party payment card scheme and not the operation of the existing MasterCard scheme “\textit{with all its benefits and ubiquity}”. It follows that, applying this general principle, the OFT would find the MMF MIF agreement to be a restriction of competition.\textsuperscript{382}

427. If it were the case, contrary to the OFT’s view, that \textit{Wouters} supports the Parties’ claim that, in assessing whether a restriction contained in the MMF MIF agreement is a restriction of competition, the OFT must consider whether it is necessary to the proper functioning of the MasterCard scheme with all its benefits and ubiquity, then, as with \textit{Gøttrup Klim}, the OFT would not accept that \textit{Wouters} establishes a principle which is of general application in this regard. Rather, the \textit{Wouters} judgment establishes a more limited principle that in some cases a regulatory rule which, having regard to its objectives, is necessary for the proper practice of a profession may fall outside Article 81(1), notwithstanding the fact that it has inherently restrictive effects. That principle would not apply to this case which does not involve regulatory rules.

428. The approach to assessing a restriction of competition which the Parties invite the OFT to adopt on the basis of both \textit{Gøttrup Klim} and \textit{Wouters} is contrary to the findings of the CFI in \textit{Métropole}:\textsuperscript{383}

“…in various judgments the Court of Justice and the Court of First Instance have been at pains to indicate that the existence of a rule of reason in Community law is doubtful…

\textit{Article [81] expressly provides, in its third paragraph, for the possibility of exempting agreements that restrict competition where they satisfy a number of conditions…It is only in the precise framework of that provision that the pro and anti-competitive aspects of a restriction may be weighed…

\textit{It is true that in a number of judgments the Court of Justice and the Court

\textsuperscript{381} See in particular paragraphs 30-32, \textit{Gøttrup-Klim}.

\textsuperscript{382} See also \textit{The Racecourse Association and others v the OFT and The British Horseracing Board and others v the OFT} [2005] CAT 9 at [167], where the CAT commented, in relation to \textit{Gøttrup Klim} and \textit{Wouters}: “What those cases show is that ostensibly restrictive arrangements which are \textit{necessary} to achieve a proper commercial objective will not, or may not, constitute an anti-competitive infringement at all” (original emphasis). The OFT considers that ‘proper commercial objective’ here means the same as ‘legitimate operation’, \textit{i.e.} the operation of a viable four-party payment card scheme and not the operation of the existing MasterCard scheme “\textit{with all its benefits and ubiquity}”.

of First Instance have favoured a more flexible interpretation of the prohibition laid down in Article [81(1)] of the Treaty…

Those judgments cannot, however, be interpreted as establishing the existence of a rule of reason in Community competition law. They are, rather, part of a broader trend in the case-law according to which it is not necessary to hold, wholly abstractly and without drawing any distinction, that any agreement restricting the freedom of action of one or more of the parties is necessarily caught by the prohibition laid down in Article [81(1)] of the Treaty. In assessing the applicability of Article [81(1)] to an agreement, account should be taken of the actual conditions in which it functions, in particular the economic context in which the undertakings operate, the products or services covered by the agreement and the actual structure of the market concerned…

That interpretation, while observing the substantive scheme of Article [81] of the Treaty and, in particular, preserving the effectiveness of Article [81(3)], makes it possible to prevent the prohibition in Article [81(1)] from extending wholly abstractly and without distinction to all agreements whose effect is to restrict the freedom of action of one or more parties. It must, however, be emphasised that such an approach does not mean that it is necessary to weigh the pro and anti-competitive effects of an agreement when determining whether the prohibition laid down in Article [81(1)] of the Treaty applies.”

429. The CFI’s findings in Métropole are of general application and the OFT has adhered to these, in accordance with section 60(2) of the CA98, in carrying out its assessment. In contrast, the Parties’ proposed framework for assessing whether a restriction of competition exists is at odds with these findings.

430. For all of the above reasons, the OFT considers that it has assessed the effect of the collective price restriction resulting from the MMF MIF agreement within the correct legal framework.

The MMF MIF has not been considered in its economic context

Summary of arguments made

431. To establish that the collective price restriction contained in the MMF MIF agreement does restrict competition, the OFT must assess competition “...within the actual context in which it would occur in the absence of the agreement in dispute.” MMF argues that the OFT has not properly considered whether the honour all cards rule is integral to the MasterCard scheme. The honour all cards rule is a key component of the economic context in which the MMF MIF agreement operates, and it must be

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384 Paragraphs 72-77, Métropole.
385 The CFI in Métropole would, of course, have had regard to the ECJ’s judgment in Gøttrup-Klim.
386 Paragraph 4.2.12, Joint written representations on the SR14.
387 Paragraph 4.26-4.28, Joint written representations on the SO.
carefully considered by the OFT to account for this economic context. This rule ensures that a cardholder can be confident that her MasterCard credit cards will be accepted by all participating merchants. This confidence is a critical feature of the MasterCard scheme, therefore the honour all cards rule is integral to the scheme.

The OFT’s response

432. The OFT accepts that a restriction must be assessed within the economic context in which it operates, and this Decision is made on the basis of exactly the approach argued for by MMF in this regard. Although the OFT has not concluded on whether the honour all cards rule is integral to the MasterCard scheme, it has nevertheless considered the operation of the MMF MIF agreement in the relevant economic context including the presence of the honour all cards rule. This has inevitably involved consideration of the purpose and effect of this rule. MMF is simply incorrect in arguing that the OFT has not properly considered the honour all cards rule.

433. The OFT considers that, even if the honour all cards rule is integral to the MasterCard scheme, this rule could be sustained within a four-party payment scheme in which interchange fees are set by bilateral agreements.388

The MMF MIF agreement is not a collective pricing agreement

Summary of arguments made

434. MMF argues that the MMF MIF is not a price in any ordinary meaning of that word (i.e. a signal which equalises supply and demand).389 It is a 'balancing mechanism' which maximises benefits, output and competitiveness of the MasterCard scheme by enabling the allocation of the costs arising from MasterCard card transactions among participating issuers and acquirers. Because the MMF MIF is not a price, reducing it would not increase the demand of acquirers participating in the MasterCard scheme for the services of issuers (as would be expected if the MMF MIF was a price). If the MMF MIF is set at the optimum amount, which MMF argues it is, then reducing it would only reduce the use of the MasterCard scheme by participants and the scheme's value to them.

The OFT’s response

435. The OFT does not accept that the MMF MIF is not a price and, consequently, does not accept that the MMF MIF agreement is not a collective pricing agreement, for the reasons given above in paragraphs 172-178.

388 See paragraphs 399-407 above.
389 Paragraphs 4.29 -4.35, Joint written representations on the SO.
436. However, the OFT recognises that when setting the MMF MIF, the Parties’ intention and the resulting effect may be to shift revenues between acquirers and issuers and to therefore affect the number of merchants and cardholders accepting and using MasterCard branded cards. MMF chooses to label this function of the MMF MIF as a 'balancing mechanism' rather than a price. However, even if the OFT were to accept the label of a balancing mechanism, it would not follow that the MMF MIF was not a price and nor would it follow that the agreement on the MMF MIF would fall outside Article 81(1) or the Chapter I prohibition. Indeed, it may be construed from this description of the MMF MIF as a balancing mechanism that the object and effect of the agreement is to restrict competition by preventing open competition from determining the revenue streams of acquirers and issuers. However, the OFT does not rely on this observation in coming to its conclusions on the restriction of competition and anyway continues to view the MMF MIF as a price.

The MMF MIF agreement is essential to the MasterCard scheme

Summary of arguments made

437. MMF argues that the MMF MIF agreement is not a restriction of competition because it is necessary to implement the legitimate operation of the MasterCard scheme, which could not operate without agreement between the Parties on the MMF MIF.  

THE MMF MIF IS ESSENTIAL TO SUSTAIN THE HONOUR ALL CARDS RULE AND OTHER FEATURES OF THE MASTERCARD SCHEME

438. MMF states that the honour all cards rule requires merchants participating in the MasterCard scheme to accept a MasterCard card as a payment method irrespective of the identity of the issuer of that card. Issuers and acquirers must transact as a result of card acceptance. Without this rule, cardholders could not be certain that MasterCard cards would be universally accepted and the benefits and utility of the MasterCard scheme would decrease.

439. Therefore, there is a clear interrelationship between the MMF MIF agreement and the honour all cards rule. The MasterCard scheme could not operate without both the honour all cards rule and the MMF MIF.  

The MMF MIF is essential to the honour all cards rule because it provides the fallback mechanism for determining the default interchange fee: if an issuer and acquirer have not agreed in advance the interchange fee which applies to transactions between them then the MMF MIF will apply. A fallback mechanism for determining the default interchange fee that will apply in the absence of bilateral agreement is essential to a four-party credit card scheme operating with an honour all cards rule.

390 Paragraphs 2.33-2.37 and 4.36-4.50, Joint written representations on the SO.
391 Paragraph 4.2.27, Joint written representations on the SR14.
440. Whether the MasterCard scheme (with all its features), as opposed to any other scheme, could operate without the MMF MIF as a fallback mechanism is the critical issue in determining whether the MMF MIF agreement is caught by Article 81(1) and the Chapter I prohibition. The OFT cannot simply consider whether an alternative scheme (with other features) would be capable of operating without the MMF MIF and would be an adequate alternative. The confidence, arising from the honour all cards rule, that MasterCard cards will be universally accepted could not be replicated in the counterfactual against which the OFT has assessed the collective price restriction. The honour all cards rule (and hence the MasterCard scheme) would be undermined if sufficient numbers of issuers and acquirers did not enter bilateral agreements.

THE OFT’S PROPOSED COUNTERFACTUAL IS NOT PLAUSIBLE

441. According to MMF, the OFT has not demonstrated that an efficient four-party payment card scheme could operate without a default MIF. The OFT has not examined the MasterCard and Visa schemes in Sweden and the Australian EFTPOS system sufficiently to allow any firm conclusions to be drawn from these, or to meet the standard of proof required to demonstrate a restriction. Specifically, MMF argues that:

(i) The OFT does not acknowledge that in the Swedish MasterCard scheme the intra-regional MIF applies as a default interchange fee pending arbitration, and that several participants in this scheme have accepted this intra-regional MIF as a default interchange fee without recourse to arbitration.

(ii) The OFT has not considered that the Australian EFTPOS system does not include an honour all cards rule and has not accounted for this difference.

(iii) The OFT has not considered that Sweden has many fewer banks than the UK meaning that scheme members do not have to conclude as many bilateral agreements as would be the case in the UK. For the MasterCard scheme to operate on this basis around 500 bilateral agreements would be required. The cost and complexity of negotiating bilateral agreements would increase as the scheme grew. This would limit growth of the MasterCard scheme and deter renegotiation of interchange fees to reflect, for example, cost changes.

*The OFT’s response*

THE MMF MIF IS ESSENTIAL TO SUSTAIN THE HONOUR ALL CARDS RULE AND OTHER FEATURES OF THE MASTERCARD SCHEME

442. The OFT has not concluded whether the honour all cards rule is integral to the MasterCard scheme. Irrespective of whether it is, the OFT considers that a viable MasterCard scheme (including an honour all cards rule) could
operate without the existence of the MMF MIF as a fallback mechanism. For the reasons given in paragraphs 398-410 above, the OFT does not accept that the MMF MIF is essential to the operation of the honour all cards rule or, on this basis, the MasterCard scheme.

443. For the reasons explained at paragraphs 421-430 above, the OFT does not accept that the critical issue for determining whether or not the MMF MIF agreement is caught by Article 81(1) or the Chapter I prohibition is whether the MasterCard scheme with all its features could operate without the MMF MIF as a fallback mechanism. As stated above, the critical issue is whether a viable four-party payment card scheme could operate without a MIF.

THE OFT’S PROPOSED COUNTERFACTUAL IS NOT PLAUSIBLE

444. The OFT has considered the Swedish Visa and MasterCard schemes and the Australian EFTPOS system sufficiently to reach the conclusions listed in paragraph 407 above.

445. The OFT does not accept that the scale of the MasterCard scheme in the UK means that it could not operate on the basis of interchange fees set by bilateral agreements. A new entrant issuer would only need to enter bilateral agreements with at most twelve acquirers. A new entrant acquirer would need to conclude agreements with approximately 50 issuers. The total number of agreements which would be present in a scheme based on bilateral agreements is not, in itself, particularly helpful in determining (i) whether this would deter issuers and acquirers from participating in the scheme; or (ii) whether the scheme would be viable. What is relevant is the burden that each individual issuer and acquirer faces in concluding agreements with other issuers and acquirers. In this regard, the OFT notes that acquirers have to enter into many agreements with merchants, on the amount of MSCs and other matters. [REDACTED]. These agreements involve similar considerations to those which would apply in determining the amount of an applicable interchange fee, and the OFT does not therefore accept that the conclusion of approximately 50 agreements with issuers would be an obstacle to the effective operation of the MasterCard scheme as a viable four-party payment card scheme.

446. To the extent that MMF argues that transaction costs of concluding bilateral agreements mean that a scheme in which interchange fees are set by this method is relatively less efficient than a scheme in which they are set by a MIF, the OFT notes that the relative efficiency of a scheme (and the burden it places on participants) is irrelevant to the finding of a restriction of competition. What matters is whether there is a viable alternative to the MasterCard scheme (including the MMF MIF). The relative efficiency of the MasterCard scheme compared with alternatives to this scheme is considered when applying the exemption conditions in Article 81(3) and section 9 of the CA98.

392 See paragraph 433 above.
393 [REDACTED].
The MMF MIF agreement falls within the Commission’s Horizontal Guidelines or is an ancillary restraint

Summary of arguments made

447. MMF has argued that the MMF MIF agreement falls within the Commission’s Notice, Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements ('the Horizontal Guidelines') when applied correctly and (in the alternative) that the MMF MIF agreement is an ancillary restraint.

THE MMF MIF AGREEMENT FALLS WITHIN THE COMMISSION’S HORIZONTAL GUIDELINES

448. According to MMF, the MMF MIF agreement contained in the UK Domestic Rules falls within the category of agreements to which the Horizontal Guidelines apply. In support of this argument, MMF relies on the Horizontal Guidelines and certain past Commission decisions. The MMF MIF agreement amounts to a horizontal co-operation agreement, within the meaning of these guidelines, as it allows the Parties to carry out an essentially pro-competitive project or activity which they could not carry out independently.

THE MMF MIF AGREEMENT IS AN ANCILLARY RESTRICTION

449. Alternatively, MMF argues that the MMF MIF agreement is not caught by Article 81(1) or the Chapter I prohibition because it is an ancillary restriction which is necessary for the operation of the MasterCard scheme. If the MMF MIF were not set at a level which enabled issuers to recover revenue and balance the system, either the scheme could not be implemented at all or it could only be implemented with considerably less success.

450. MMF states that the CFI in Métropole confirmed that, in considering the concept of an ancillary restriction, a provision that would otherwise be a restriction of competition may be lawful by reason of its role and purpose. Specifically, it said that this involves:

"...determining whether in the specific context of the main operation, the restriction is necessary to implement that operation. If, without the

395 Paragraphs 4.51-4.71, Joint written representations on the SO.
396 See paragraphs 4.2.18-4.2.19 and footnote 132, Joint written representations on the SR14.
397 See, for example, paragraphs 4.1.1 and 4.1.2, 4.2.12-4.2.20 and 4.4.3-4.4.9, Joint written representations on the SR14; paragraphs 4.51, 4.54, 4.61-4.62, 4.64 and 4.65, Joint written representations on the SO.
398 See in particular, paragraphs 4.2.18-4.2.33, Joint written representations on the SR14; paragraphs 4.51-4.71, Joint written representations on the SO.
399 Paragraphs 109-111.
*restriction, the main operation is difficult or even impossible, the restriction can be regarded as objectively necessary for its implementation."

The OFT’s response

THE MMF MIF AGREEMENT FALLS WITHIN THE COMMISSION’S HORIZONTAL GUIDELINES

451. The OFT does not accept MMF’s argument that the UK Domestic Rules, including the agreement on the MMF MIF, fall outside the scope of Article 81(1) and the Chapter I prohibition on the grounds that they are a horizontal co-operation agreement.

452. There are serious questions regarding the applicability of the Horizontal Guidelines to arrangements such as those which the OFT has to consider in this case. Similarly, the Commission decisions cited by MMF were concerned with different types of agreement. However, for the purposes of this Decision the OFT is prepared to assume, in the Parties’ favour, that the Horizontal Guidelines are (at least in general terms) applicable to these arrangements and, hence, that the OFT is required to have regard to them.

453. On this basis, and having regard also to the Article 81(3) Notice, the OFT concludes that there is a restriction of competition for the purposes of Article 81(1) and the Chapter I prohibition for the reasons explained in the following paragraphs.

Application of the Article 81(3) Notice and the “Basic Principles for the assessment under Article 81” part (paragraphs 17 to 26) of the Horizontal Guidelines

454. The provisions of the Article 81(3) Notice and the Horizontal Guidelines have to be understood in the light of the judgment of the CFI in Métropole, to the effect that pro- and anti-competitive effects of an agreement are not to be weighed at the stage of deciding whether or not an agreement has an appreciable effect on competition for the purposes of Article 81(1). In accordance with section 60(2) of the CA98, the OFT may not act inconsistently with this principle when determining whether the MMF MIF agreement has an appreciable effect on competition for the purposes of Article 81(1) and the Chapter I prohibition.

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400 For example, the Commission found in the Visa MIF decision that Visa scheme did not involve undertakings cooperating in order to provide a single joint service or joint product (see paragraph 65). The OFT considers that this is equally the case for the MasterCard scheme; instead, issuers and acquirers each offer distinct services to distinct customers (cardholders and merchants respectively) in the context of a credit card transaction. While demand from these customers is inter-dependent (a credit card transaction will result in demand from a merchant for acquiring services and demand from a cardholder for issuing services), issuing services and acquiring services are distinct activities, involving different specialisations and different costs.

401 See further Annex 9 (Other EC case law relied on by the parties) of this Decision.
Therefore, when paragraph 19 of the Horizontal Guidelines refers to the need to identify "negative market effects", and paragraph 24 of the Article 81(3) Notice refers to a reasonable probability of "negative effects on prices, output, innovation or the variety or quality of goods and services", they cannot mean 'negative market effects not outweighed by countervailing benefits.'

This is confirmed by the Article 81(3) Notice, paragraph 11 of which states:

"The assessment under Article 81 thus consists of two parts. The first step is to assess whether an agreement between undertakings...has an anti-competitive object or actual or potential anti-competitive effects. The second step, which only becomes relevant when an agreement is found to be restrictive of competition, is to determine the pro-competitive benefits produced by that agreement and to assess whether these pro-competitive effects outweigh the anti-competitive effects. The balancing of anti-competitive and pro-competitive effects is conducted exclusively within the framework laid down by Article 81(3)."*402

(emphasis added)

It follows that MMF is mistaken when it asserts that the correct test of whether or not the MMF MIF agreement appreciably affects competition, "requires an assessment of whether the full Scheme could continue to function properly without the risk of significant shrinkage or reduction in benefits..."*403

In addition, as regards paragraph 19 of the Horizontal Guidelines and paragraph 24 of the Article 81(3) Notice, the MMF MIF agreement does have a negative market effect as to prices:

(i) The MMF MIF agreement is a restriction of competition in the wholesale market because it severely restricts the incentives for parties to conclude bilateral agreements on interchange fees by negotiation or arbitration. In particular, it restricts competition in this regard to a greater extent than would the honour all cards rule alone.

(ii) In the acquiring market, the MMF MIF agreement has a direct effect on the prices charged by acquirers to merchants, as it operates as a collectively-set common price floor for MSCs.

*402 Métropole is given as authority for the proposition in the final sentence. The judgment is referred to also at paragraphs 24, 29, 30, 31 and 42 of the Article 81(3) Notice.
*403 Paragraph 4.4.28(a), Joint written representations on the SR14. See also paragraphs 4.61, 4.64 and 4.65, Joint written representations on the SO, suggesting that the OFT ought to ask itself whether the MMF MIF agreement is necessary for "...a payment card scheme with the benefits and ubiquity..." of the present MasterCard scheme; "...a Scheme with the utility of..." the present MasterCard scheme; or "...to allow the degree of compatibility and interoperability..." offered by the present MasterCard scheme.
459. MMF suggests that, in order to establish that the MMF MIF agreement has a negative effect on prices for these purposes, the OFT must prove that interchange fees (and hence MSCs) would be lower in the absence of any MIF agreement.\textsuperscript{404} This is incorrect.

460. Paragraph 16 of the Article 81(3) Notice states that:

“Agreements are caught by the prohibition rule of Article 81(1) when they are likely to have an appreciable adverse impact on the parameters of competition on the market, such as price, output, product quality, product variety and innovation. Agreements can have this effect by appreciably restricting rivalry between the parties to the agreement or between them and third parties.”

(emphasis added)

461. The parameter of competition as to price is adversely impacted by the MMF MIF agreement in the wholesale market because it severely restricts the incentives for the Parties individually to enter into bilateral agreements, \textit{i.e.} competition between issuers, and between acquirers, to obtain a more attractive interchange fee than their rivals is severely restricted. It is not necessary to demonstrate, in addition, that were this parameter of competition not restricted, there would be a better (\textit{i.e.} more pro-competitive) outcome. Rather, disadvantages for competition that might result from the counter-factual of bilateral agreements (including the possibility that bilateral interchange fees could generally be higher than a collectively-set MIF) are properly considered in deciding whether or not the criteria for exemption are met.

462. Similarly, in the acquiring market, because the MMF MIF (which acquirers are themselves involved in setting) acts as a collectively-set common price floor for MSCs, it restricts the scope for intra-scheme competition between acquirers on the level of MSCs. While bilateral interchange fees would also act as a price floor for MSCs, a system of bilaterally negotiated interchange fees would not necessarily lead to interchange fees that were uniform to all parties or (it follows) a \textit{common} price floor for acquirers’ MSCs. Hence, the MMF MIF has an appreciable adverse impact also on the parameter of price competition between acquirers in the acquiring market.

463. Paragraph 24 of the Horizontal Guidelines, states:

"Some agreements do not fall under Article 81(1) because of their very nature. This is normally true for cooperation that does not imply a coordination of the parties’ competitive behaviour in the market such as – i) cooperation between non-competitors, ii) cooperation between competing companies that cannot independently carry out the project or activity covered by the cooperation,

\textsuperscript{404} See paragraphs 4.68-4.69 Joint written representations on the SO.
iii) cooperation concerning an activity which does not influence the relevant parameters of competition. These categories of agreement could only come under Article 81(1) if they involve firms with significant market power and are likely to cause foreclosure problems vis-à-vis third parties.”

464. Similarly, paragraph 18(2) of the Article 81(3) Notice provides:

“...certain restraints may in certain cases not be caught by Article 81(1) when the restraint is objectively necessary for the existence of an agreement of that type or nature. Such exclusion of the application of Article 81(1) can only be made on the basis of objective factors external to the parties themselves and not the subjective views and characteristics of the parties. The question is not whether the parties in their particular situation would not have accepted to conclude a less restrictive agreement, but whether given the nature of the agreement and the characteristics of the market a less restrictive agreement would not have been concluded by undertakings in a similar setting. For instance, territorial restraints in an agreement between a supplier and a distributor may for a certain period of time fall outside Article 81(1), if the restraints are objectively necessary in order for the distributor to penetrate a new market...”

465. The OFT does not accept (as has been argued by RBSG) that the MMF MIF agreement falls within the first or third sub-paragraphs of paragraph 24 of the Horizontal Guidelines. In relation to the second sub-paragraph of paragraph 24 and paragraph 18(2) of the Article 81(3) Notice, cooperation in the form of collective price setting through a MIF cannot be said to be essential to the proper functioning of the MasterCard scheme, as evidenced by the Swedish payment card system and the EFTPOS system in Australia which operate on the basis of bilaterally negotiated interchange fees between issuers and acquirers. MMF suggests that "nothing short of the present MIF agreement would ensure the proper functioning of the scheme", but here, as elsewhere in its representations in this case, MMF is referring to the scheme as constituted as opposed to a viable four-party credit card scheme. This would therefore be the wrong test to apply by reference to the CFI’s judgment in Métropole.

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405 See Mr Nigel Parr: pages 5 and 29-31, Transcript of RBSG oral representations on the SR14.
406 As regards the first bullet-point, the OFT considers that the MMF MIF agreement must be regarded as coordinating competitive behaviour at least because the MIF is such a large component of MSCs and because a rise in the MIF can be expected to lead to a proportionate rise in MSCs. The latter point was conceded by MMF’s expert, Professor von Weizsäcker (see Professor von Weizsäcker: page 24, Transcript of joint oral representations on the SR14). For the same reasons, and for the reasons given in paragraphs 461-462 above, the MMF MIF agreement must influence the "relevant parameters of competition" for the purpose of the third bullet-point.
407 Paragraph 4.2.28, Joint written representations on the SR14. See also paragraphs 4.61 and 4.64-4.65, Joint written representations on the SO.
408 See paragraphs 421-430 above.
466. In any event, even where they are applicable, paragraph 24 of the Horizontal Guidelines and paragraph 18(2) of the Article 81(3) Notice are not, by their terms, conclusive as to whether agreements of the kind they describe are or are not caught by Article 81(1) (or the Chapter I prohibition). Paragraph 24 of the Horizontal Guidelines states that it “is normally true” that cooperation of the kinds described will not fall under Article 81(1) and paragraph 18(2) of the Article 81(3) Notice states that restraints of the kinds described “may in certain cases” not be caught by Article 81(1).

Application of the parts of the Horizontal Guidelines relating specifically to production agreements (paragraphs 78 to 114) and commercialisation agreements (paragraphs 139 to 158).

467. If it were the case that the paragraphs of the Horizontal Guidelines relating specifically to joint production agreements and to commercialisation agreements were properly to be considered applicable to the arrangements which the OFT has to consider, these would lead the OFT to the conclusion that there is a restriction of competition for the purposes of Article 81(1) and the Chapter I prohibition.

468. As regards those paragraphs of the Horizontal Guidelines relating to joint production agreements, paragraph 83 states that the main source of competition problems that may arise is “the coordination of the parties’ competitive behaviour as suppliers.” Paragraph 84 clarifies that, “The fact that parties are competitors does not automatically cause the coordination of their behaviour. In addition the parties also normally need to cooperate with regard to a significant part of their activities in order to achieve a substantial degree of commonality of costs. The higher the degree of commonality of costs, the greater the potential for a limitation of price competition, especially in the case of homogenous products.”

469. Similarly, in the section of the Horizontal Guidelines relating specifically to commercialisation agreements, paragraph 146 states:

“…depending on the cost structure of the commercialisation…the actual scope for price competition at the final sales level may be limited. Joint commercialisation agreements therefore can fall under Article 81(1) if they influence a significant part of the parties’ final cost.”

470. The agreement on the MMF MIF influences a significant part of the parties’ final costs, in particular because the MMF MIF acts as a common price floor for MSCs. This has been acknowledged by MCE/MCI.409 In addition, the services provided by acquirers to merchants in the acquiring market can be considered relatively homogenous. It follows that these paragraphs of the Horizontal Guidelines also, were they applicable to the arrangements which the OFT has to consider, would lead the OFT to the conclusion that there is a restriction of competition for the purposes of Article 81(1) and the Chapter I prohibition.

409 Paragraph 3.3.5, MCE/MCI Joint written representations on the R14 (23 January 2002).
471. MMF relies on paragraph 87 of the Horizontal Guidelines (in relation to production agreements specifically), which states:

"Even production agreements between competitors do not necessarily come under Article 81(1). First, cooperation between firms which compete on markets closely related to the market directly concerned by the cooperation, cannot be defined as restricting competition, if the cooperation is the only commercially justifiable possible way to enter a new market, to launch a new product or service or to carry out a specific project..."

472. However, as explained at paragraph 465, cooperation in the form of collective price setting through a MIF cannot be said to be essential to the proper functioning of the MasterCard scheme.

Approach of the Commission

473. The above analysis is consistent with the Commission’s approach to the Horizontal Guidelines in its Visa MIF decision.410

THE MMF MIF AGREEMENT IS AN ANCILLARY RESTRAINT

474. The OFT does not accept MMF’s arguments that the MMF MIF agreement is an ancillary restraint for the reasons given below.

475. First, MMF has quoted selectively from the CFI’s findings as to the concept of an ancillary restriction. In its Métropole judgment, the CFI found that:

"...an 'ancillary restriction' covers any restriction which is directly related and necessary to the implementation of the main operation...

In its notice on ancillary restrictions [Notice regarding restrictions ancillary to concentrations]411 the Commission rightly stated that a restriction ‘directly related’ to implementation of a main operation must be understood to be any restriction which is subordinate to the implementation of that operation and which has an evident link with it...

The condition that a restriction is necessary implies a two-fold examination. It is necessary to establish, first, whether the restriction is objectively necessary for the implementation of the main operation and, second, whether it is proportionate to it...

As regards the objective necessity of a restriction, it must be observed that inasmuch as has been shown..., the existence of a rule of reason in Community competition law cannot be upheld, it would be wrong, when classifying ancillary restrictions, to interpret the requirement for objective necessity as implying a need to weigh the pro and anti-competitive effects

410 See, in particular, paragraphs 56-60 of the Visa MIF decision.
of an agreement. Such an analysis can take place only in the specific framework of Article [81(3)] of the Treaty...

Consequently,...examination of the objective necessity of a restriction in relation to the main operation cannot but be relatively abstract. It is not a question of analysing whether, in the light of the competitive situation on the relevant market, the restriction is indispensable to the commercial success of the main operation but of determining whether, in the specific context of the main operation, the restriction is necessary to implement that operation. If, without the restriction, the main operation is difficult or even impossible to implement, the restriction may be regarded as objectively necessary for its implementation...

Contrary to the applicants' claim, none of the various decisions to which they refer show that the Commission carried out an analysis of competition in classifying the relevant clauses as ancillary restrictions. On the contrary, these decisions show that the Commission’s analysis was relatively abstract...

Where a restriction is objectively necessary to implement the main operation, it is still necessary to verify whether its duration and its material and geographic scope do not exceed what is necessary to implement that operation. If the duration or the scope of the restriction exceed what is necessary in order to implement the operation, it must be assessed separately under Article [81(3)] of the Treaty...

476. Similarly, the CFI explained the consequence of classification as an ancillary restriction as follows:

"If it is established that a restriction is directly related and necessary to achieving a main operation, the compatibility of that restriction with the competition rules must be examined with that of the main operation. Thus, if the main operation does not fall within the scope of the prohibition laid down in Article [81(1)] of the Treaty, the same holds true for the restrictions directly related and necessary for that operation...If, on the other hand, the main operation is a restriction within the meaning of Article [81(1)] but benefits from an exemption under Article [81(3)] of the Treaty, that exemption also covers those ancillary restrictions."

477. In this context, the 'main operation' refers to the minimum requirements for a viable four-party payment card scheme. Hence, the decisive question to be answered, as explained above, is whether it would be possible to have a viable four-party payment card scheme without the MMF MIF agreement. It is sufficient to take a 'relatively abstract' approach to answering that question. A full analysis of competition is not required and it is not legitimate to weigh the pro-competitive and anti-competitive effects of the agreement at this stage.

412 Paragraphs 104-112, Métropole.
413 Paragraphs 115-116, Métropole.
414 See paragraphs 442-443.
Arbitration is not a viable alternative fallback mechanism

Summary of arguments made

478. MMF argues that the OFT wrongly assumes that arbitration could operate as an alternative fallback mechanism to the MMF MIF. Arbitration alone would be an inefficient and ineffective process, and cannot be considered a viable alternative fallback mechanism.

479. For arbitration to operate as a fallback mechanism, principles for determining all arbitrations would have to be developed and applied universally. The principles are likely to be identical to those adopted by MMF in setting the MMF MIF and there is therefore no reason why an interchange fee set by arbitration would be less than the MMF MIF.

480. Setting interchange fees requires consideration of factors other than the costs of issuers and acquirers (e.g. competition from competing payment methods, benefits of scheme expansion, encouraging uptake of new technology). Collecting and presenting evidence concerning these factors at arbitration would be difficult.

481. Arbitration based only on individual costs of parties to the arbitration would create disincentives for issuers and acquirers to reduce costs or increase efficiency, because inefficient costs could be recovered through the interchange fee.

482. Arbitration based on average costs would yield “broadly the same result” as the process MMF engages in when setting the MMF MIF. The only individual factor which the arbitration might want to take into account would be if one party were able to lower the other’s costs but, where that is the position, there would be no more scope for one party to be rewarded for a reduction in the other’s costs under a system of bilateral negotiation/arbitration than under the existing system, where parties can agree interchange fees bilaterally which differ from the MMF MIF.

483. MMF states that “…there is every expectation that different arbitrations would lead to inconsistent results because of inconsistencies in approach adopted by different arbitrators.” This would lead to a non-level playing field between participants in the MasterCard scheme. Arbitration would not therefore be workable.

415 Paragraphs 4.79-4.101, Joint written representations on the SO.
416 Paragraph 4.83, Joint written representations on the SO.
417 Paragraph 4.94, Joint written representations on the SO.
The OFT’s response

484. The OFT does not accept that a MIF is the only possible fallback mechanism for determining a default interchange fee in a four-party payment card scheme. Arbitration could provide a fallback mechanism sufficient to support a viable four-party payment card scheme. It is not necessary for the OFT to speculate as to the precise nature of any arbitration process used to set an interchange fee. It is enough for the OFT to show that interchange fees could be set by arbitration. Provision in the UK Domestic Rules and in the Swedish MasterCard and Visa schemes for interchange fees to be set by arbitration (albeit, in the UK context, there is a prior fallback mechanism in the form of the default MIF) suggest that the amount of an interchange fee is capable of being set by arbitration.418

485. Similarly, it is not necessary for the OFT to show that a four-party payment card scheme with bilaterally agreed interchange fees and arbitration as a fallback mechanism would be as efficient as, or more efficient than, a four-party payment card scheme with a MIF. The OFT accepts that certain forms of arbitration, based only on individual costs, could create disincentives for issuers and acquirers to reduce costs or increase efficiency. This does not affect the OFT’s conclusion that arbitration is a fallback mechanism sufficient to support a viable four-party payment card scheme.

486. In addition, the OFT does not accept that the complexity of factors to be considered by arbitrators in determining a default interchange fee, or that the complexity or confidentiality of information they would have to consider, precludes an interchange fee being determined by arbitration. Many instances of commercial arbitration involve matters of considerable complexity and the consideration of confidential information.

487. There is no reason why principles for determining all arbitrations would be identical to those adopted by MMF in setting the MMF MIF. To the extent that any arbitration would have to be based on agreed principles, the OFT does not consider that these principles would necessarily be prescriptive. In any event, no matter how prescriptive agreed principles for arbitration were, there would always be a need for the arbitrator to exercise judgement (this is the nature of arbitration). Accordingly, there is no reason why bilateral interchange fees determined by arbitration would be the same as the (collectively agreed) MMF MIF or each other. MMF itself accepts that arbitration, based on costs of the parties to the arbitration, would be likely to lead to variations in interchange fees.419

488. Even if arbitration were to be based largely on average costs, MMF accepts that the arbitration rules might want to take account of the ability of one party to the arbitration being able to lower the other’s costs because “the arbitration process would need to encourage such innovations.” This too would introduce variations in interchange fees as

418 See paragraphs 399-407 above.
419 Paragraph 4.94, Joint representations on the SO.
compared to the MMF MIF. MMF suggests that scheme participants in that position would be in a position to negotiate a bilateral interchange fee different from the MMF MIF but MMF’s reasoning in this regard depends on what seems to be an unrealistic assumption, i.e. that the participant which has a method of producing cost-savings is free to choose whether or not to use that method in respect of the transactions of any given issuer. Where that assumption does not hold, then the existence of the MMF MIF means there is very little incentive for issuers and acquirers to enter into bilateral agreements (see paragraphs 397-399 above).

489. Lastly, the OFT does not accept that arbitration is not a credible method of determining an interchange fee simply because individual arbitrations could have different results. To the extent that arbitration leads to a “…non-level playing field…” in terms of the applicable interchange fees paid by acquirers (e.g. recognising individual efficiencies), the OFT considers that this provides evidence that removal of the MMF MIF would, indeed, be the removal of a restriction of competition.

**Competition would be the same with or without the MMF MIF**

**Summary of arguments made**

490. MMF argues that the OFT wrongly assumes that the MMF MIF removes competition which would exist if interchange fees were negotiated bilaterally between issuers and acquirers. According to MMF, there is no reason why competition without the MMF MIF would differ from competition with the MMF MIF. Acquirers already operating within the MasterCard scheme should be in a good position to negotiate a reduced interchange fee with issuers.421

491. In addition, in a four-party payment card scheme the volume of business between issuers and acquirers depends on third party activity (that of cardholders and merchants). Because of the honour all cards rule, issuers and acquirers cannot cease dealing with each other. Both groups would have equal power in negotiating bilateral agreements with neither group having decisive power. In this situation, it is unlikely that bilateral interchange fees would be negotiated which differ from the MMF MIF. In essence, there is:

> “…no scope for issuers to compete for the business of acquirers or for acquirers to compete for the business of issuers. As between issuers and acquirers there is no opportunity for effective negotiation on ‘price’ towards a competitive equilibrium since neither issuer nor acquirer can withdraw from the exchange. Moreover, the volume of business between each issuer and acquirer is dependent on choices made by third parties, namely cardholders and merchants. Thus, there is no proper incentive for issuers to reduce their interchange fees in exchange for winning more business from acquirers. The absence of scope for competition applies equally in relation to acquirers: they are not in competition with each other

420 Paragraph 4.94, Joint written representations on the SO.
421 Paragraph 4.91, Joint written representations on the SO.
for issuers’ business. They are obliged to deal with all issuers, subject to the rules of the Scheme. This absence of competition creates inherent difficulties for the negotiation process: an agreement must be reached but neither party has any leverage in the negotiation process. 

492. Therefore, issuers and acquirers have no incentive to negotiate bilateral agreements containing more attractive terms (e.g. a reduced interchange fee). This means that there is no indication that the competition which would exist without the MMF MIF would be different from that which exists with the MMF MIF.

493. Specifically, MMF argues that the OFT does not acknowledge that a scheme based on bilateral agreements would confer market power on incumbent issuers and acquirers by requiring potential entrants to negotiate agreements with all incumbents. This would increase the barriers of entry to the MasterCard scheme. In addition, the OFT has not considered that in a scheme based on bilateral agreements, interchange fees would be determined primarily by issuers. Issuers can determine how much money to pass on to acquirers and can be expected to seek interchange fees which are higher than the MMF MIF (to maximise their revenue).

494. Since each issuer has an incentive to obtain better interchange fees than other issuers, any differentiation between bilateral agreements would be likely to drive interchange fees upwards.

The OFT’s response

495. The OFT does not accept MMF’s argument that competition would be the same with or without the MMF MIF. Although it is true that, as a result of the honour all cards rule, issuers in the MasterCard scheme cannot compete directly for the business of acquirers in the scheme and vice versa, it does not follow that there would be no competitive process involved in setting interchange fees bilaterally. As issuers compete in the issuing market it will be in their interest to negotiate higher interchange fees than their competitors and as acquirers compete in the acquiring market it will be in their interest to negotiate lower fees than their competitors. Issuers will differ from each other, as will acquirers, in various ways, for example in the attractiveness of the portfolio of business they bring to the scheme, their relative efficiency and their desire for a quick settlement of interchange fees. In these circumstances it is reasonable to assume that not all bilateral negotiations will lead to identical outcomes. Moreover, early settlements will create competitive constraints on later ones.

496. In principle, bilaterally negotiated interchange fees are possible at present but none actually exists because the MMF MIF strongly deters issuers and acquirers from entering bilateral agreements and prevents card issuers developing independent pricing policy in relation to the wholesale services

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422 Paragraph 2.34(b), Joint written representations on the SO.
423 Paragraph 4.101, Joint written representations on the SO.
they provide to acquirers. It provides a focal point for potential bilateral negotiations that is unlikely to be departed from, since there is no alternative outcome that is more beneficial to both the issuer and the acquirer, and either party can automatically (and without cost) rely on the MIF if unhappy with the other party’s offer. Without the MMF MIF, issuers and acquirers would have more incentive to determine independently an interchange fee to apply to transactions between them. Absent an effective focal point, individual acquirers/issuers might be able to negotiate a lower/higher fee on the basis of what they bring to the scheme relative to their competitors. This would especially be the case if any arbitration in the event of dispute did take efficiency arguments into account.

497. The muting of incentives for issuers and acquirers already operating within the MasterCard scheme if negotiating bilateral agreements, which MMF argues would result from:

(i) the honour all cards rule; and/or

(ii) dependence of the number of transactions between issuers and acquirers on cardholder and merchant activity,

does not alter the fact that the existence of the MMF MIF further reduces incentives for issuers and acquirers to determine interchange fees by bilateral agreement which could (i) differ from the amount of the MMF MIF and (ii) vary between bilateral agreements (both of which characteristics are observed in the Swedish MasterCard scheme, where an honour all cards rule exists).

498. In addition, the OFT does not accept that in a scheme without a MIF, issuers and acquirers are unlikely to agree applicable interchange fees in advance of transactions. The honour all cards rule requirement to transact may create incentives for issuers and acquirers to agree terms for dealing in advance, thereby ensuring that a framework for transaction exists and avoiding the “anarchic situation” which would otherwise result (and which plainly does not exist in the Swedish MasterCard scheme). This incentive is heightened by the fact that a bilateral agreement will determine both the cost of interchange fee (for the acquirer in any transaction) and the revenue derived from the interchange fee (for the issuer in any transaction). Irrespective of whether issuers and acquirers have equal power in negotiating terms of dealing (with neither party having decisive power), if each group derives the benefits of participation in the MasterCard scheme claimed by MMF, and must transact because of the honour all cards rule, then it is more likely than not that issuers and acquirers would seek certainty in transactions by agreeing terms in

424 See paragraphs 397-398 above.

425 In the Swedish MasterCard scheme, >20% of <40% bilateral agreements (accounting for >90% of transactions) differ from the intra-regional MIF which applies as a default interchange fee pending arbitration (see Mr Tom Sharpe QC: page 89, Transcript of joint oral representations on the SO and Letter from MCE to Service de la concurrence, Belgium (24 June 2005)).

426 Paragraph 4.78, Joint written representations on the SO.
advance (even where terms may be unsatisfactory to one or both parties and may be subject to later arbitration).

499. Whether or not interchange fees set by bilateral agreement would generally exceed the MMF MIF does not affect the OFT’s finding that the collective price restriction does restrict competition.\(^{427}\) The OFT finds that the collective price restriction constitutes a restriction of competition whether or not it leads to a higher MIF than the interchange fees that would generally result from bilateral agreements.\(^{428}\) In any event, MMF’s assumption that issuers would demand and receive increased interchange fees in a bilateral agreement based scheme\(^{429}\) appears difficult to reconcile with its argument\(^{430}\) that negotiation of agreements with incumbent acquirers would be a significant barrier to entry for issuers seeking to join the MasterCard scheme. The OFT agrees that joining issuers are unlikely unilaterally to determine the interchange fees paid by incumbent acquirers. There is clearly a distinction between the negotiating position of incumbent issuers and issuers seeking to enter the scheme, however this does not affect the OFT’s view that, without the MMF MIF, issuers and acquirers will act on incentives to negotiate interchange fees bilaterally.

REPRESENTATIONS AND SUBMISSIONS ON COLLECTIVE PRICE RESTRICTION IN THE ACQUIRING MARKET

Summary of arguments made

500. MMF argues\(^{431}\) that the OFT’s finding of a restriction of competition in the acquiring market cannot be based on the fact that the MMF MIF is a common cost for all acquirers. The effect of the MMF MIF on competition is no different from the effect of a common input in any other market. Without such a common input the MasterCard scheme could not operate effectively. In addition, the OFT’s counterfactual in which interchange fees are set by bilateral agreements would be likely to result in interchange fees which are equal to or more than the MMF MIF. Accordingly, the common cost to acquirers with the MMF MIF is unlikely to be more than it would be in the OFT’s counterfactual without the MMF MIF.

\(^{427}\) See also paragraphs 459-462 above.

\(^{428}\) In *The Racecourse Association and others v the OFT and The British Horseracing Board and others v the OFT* [2005] CAT 9 at [189], the CAT found that, since the OFT asserted that a restriction had the effect of increasing a price, it was for the OFT to prove that effect on the balance of probabilities. That is not, however, the situation in this case: the OFT is not required to show in this Decision that the collective price restriction has the effect of increasing the MMF MIF from the levels that would generally be likely to prevail with bilateral agreements on interchange fees because this is not an effect which the OFT asserts is a result of this restriction (as opposed to the extraneous costs restriction). The effects of the collective price restriction are as set out in paragraphs 395-415 above.

\(^{429}\) Paragraph 2.37(d), Joint written representations on the SO.

\(^{430}\) Paragraphs 4.45-4.46, Joint written representations on the SO.

\(^{431}\) Paragraphs 4.103-4.107, Joint written representations on the SO.
The OFT’s response

501. MMF accepts that the MMF MIF is a common cost for all acquirers. It is also clearly a cost arising from a collective agreement between the Parties, including acquirers, who are competitors in the acquiring market identified above. Where any other input cost were set by these means, this would be likely to constitute a restriction of competition for the purposes of Article 81(1) or the Chapter I prohibition.

502. Whether bilateral agreements would result in interchange fees which in general exceed the MMF MIF (and a higher cost on average for acquirers) is immaterial. What is relevant is that, in the OFT’s counterfactual without the MMF MIF, issuers and acquirers would have incentives to negotiate bilateral interchange fees which vary from the MMF MIF. This is likely, in turn, to lead to increased variation and competition in MSCs. Irrespective of the actual amount of interchange fees set by bilateral agreements, a four-party payment card scheme involving bilateral agreements would not have the features of the MasterCard scheme which the OFT considers result in a restriction of competition through the collective price restriction. The likely amount of interchange fees set by bilateral agreement is only relevant when weighing the pro- and anti-competitive effects in considering whether the MMF MIF agreement meets the exemption conditions in Article 81(3) and section 9 of the CA98.\(^{432}\)

APPRECIABLE RESTRICTION OF COMPETITION

503. An agreement will be caught by Article 81(1) and/or the Chapter I prohibition only if it has as its object or effect an appreciable restriction of competition within the common market in the case of Article 81(1), or the UK in the case of the Chapter I prohibition.

504. As a result of the collective price restriction, the OFT considers that (irrespective of (i) whether debit cards are included in the relevant markets and (ii) whether the Parties’ market shares fall beneath any relevant threshold) the MMF MIF agreement has an appreciable effect on competition for the purposes of Article 81(1) and the Chapter I prohibition, on the basis that:

(i) it directly sets the amount of the interchange fees which an issuer charges an acquirer;

(ii) it operates as a collectively agreed common and significant price floor for the MSCs charged by acquirers to merchants;

(iii) it is one of a network of similar agreements (the other being the MIF applicable to UK domestic transactions under the Visa scheme) which have a cumulative effect on the relevant markets;\(^{433}\) and

\(^{432}\) See also paragraphs 459-462 above.

\(^{433}\) See also paragraph 8 of the Notice on Agreements of Minor Importance.
transactions involving the MasterCard scheme are of substantial importance to the UK economy (see paragraph 510 below).

505. The Commission’s approach in determining whether an agreement has an appreciable effect on competition for the purposes of Article 81(1) is set out in the Commission Notice on agreements of minor importance which do not appreciably restrict competition under Article 81(1) of the Treaty establishing the European Community (‘Notice on Agreements of Minor Importance’). 434

506. The Notice on Agreements of Minor Importance states that agreements between undertakings which affect trade between Member States do not (subject to certain exceptions) appreciably restrict competition within the meaning of Article 81(1) if the aggregate market share of the parties to the agreement does not exceed 10 per cent on any of the relevant markets affected by the agreement where the agreement is made between competing undertakings (i.e. undertakings which are actual or potential competitors on any of the markets concerned). The Parties’ aggregate share of both the wholesale and acquiring markets is 100 per cent, which clearly exceeds the threshold set out in the Notice. In addition, the Parties’ share of the issuing market in 2004 was 35 per cent by value and 36 per cent by volume. 435 These shares too considerably exceed the thresholds above which appreciability may be found as set out in the Notice on Agreements of Minor Importance. The OFT therefore considers that, having regard to this Notice, the MMF MIF agreement restricts competition to an appreciable extent for the purposes of Article 81(1) and the Chapter I prohibition.

507. The OFT does not consider that debit cards are sufficiently substitutable with credit and charge cards to form part of the relevant markets it has identified. Even if debit cards were to be included in the wholesale, acquiring and issuing markets, this would not affect the OFT’s conclusion on the appreciability of the restrictions in those markets since in 2004 the share of plastic card purchase transactions in the UK made by means of UK-issued MasterCard branded credit and charge cards and Maestro branded debit cards was 41.3 per cent by value and 43.7 per cent by volume. 436

508. MMF has argued (on the basis of MasterCard’s share of plastic card purchase transactions in the UK before the migration of Switch branded debit cards to MasterCard’s Maestro branded debit cards437) that,

435 See Tables 4 and 5 above.
436 See Tables 6 and 7 above.
437 See footnote 7 above on the migration of Switch branded debit cards to MasterCard’s Maestro branded debit cards. In 2000, the share of plastic card purchase transactions in the UK made by means of UK-issued MasterCard credit and charge cards was 16.7 per cent by value and 12.4 per cent by volume. In 2001, the share of plastic card purchase transactions in the UK made by means of UK-issued MasterCard credit and charge cards was 15.7 per cent by value and 11.9 per cent by volume. In 2003, after members of the Switch scheme had begun migrating to MasterCard’s Maestro brand, the share of plastic...
according to the Horizontal Guidelines, a market share threshold of 20 per cent is the point at which an assessment must be made of the likely impact of a joint production agreement on the market in order to establish the application of Article 81(1).  

509. As stated, the OFT considers that there are serious questions regarding the applicability of the Horizontal Guidelines to arrangements such as those which the OFT has to consider in this case (see paragraphs 451-473 above). For the purposes of this Decision, the OFT is prepared to assume in the Parties’ favour that the Horizontal Guidelines are applicable to these arrangements and, hence, that it is required to have regard to them. In any event, however, the OFT notes that the Horizontal Guidelines explicitly state that “there is no absolute market share threshold which indicates that a production agreement creates some degree of market power and thus falls under Article 81(1)”.  

510. Transactions involving the MasterCard scheme are of substantial importance to the UK economy. In 2004, MasterCard credit and charge cards were used for 704 million transactions in the UK, at a value of £42.7 billion. Based on available data, the OFT estimates that the revenue generated by transactions involving the MasterCard scheme for domestic payments alone, and payable to issuers under the MMF MIF agreement, can be estimated at approximately £[384-470] million per annum. This is estimated to represent on average [10-25] per cent of total issuer revenue in the UK. In addition, in recent years credit cards have been attracting an increasing share of unsecured lending to individuals in the UK. While total unsecured consumer credit has grown by 40 per cent between 1999 and 2003, that accounted for by credit cards has grown by 58 per cent, and in 2003 issuers advanced consumers £133

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439 Paragraph 93, Horizontal Guidelines.
440 Tables 4 and 5 above.
441 Based on an average level of approximately [0.9-1.1] per cent for the MMF MIF (see Letter from Lovells to the OFT (17 May 2004)) on MasterCard purchase transactions amounting to £42,757 million by value in the UK for the year 2004. For the year 1997, the MIF revenue of the Visa and MasterCard credit and charge card payment systems in the UK was estimated at approximately £650 million: Table D3.6, Cruickshank Report. Datamonitor has estimated that in 2001, the UK credit card industry generated £856 million interchange revenue: page 12, Datamonitor, The Future of Interchange BFFS0156 (October 2002). The value of purchase transactions in the UK made using credit and charge cards has increased by almost 25% between 2001 and 2004, APACS Plastic Card Review 2005, Table 4B.
442 The OFT does not want to reveal the exact value, since this would reveal confidential information on issuers’ revenues, which was supplied to the OFT by a sample of MasterCard issuers for the period 2001 to 2003, in response to OFT’s request for information under section 26 of the CA98.
443 See also paragraph 71 of the Visa MIF decision, where the Commission took account of similar considerations in assessing the appreciable effect of the Visa MIF.
billion on their credit cards which represented 64 per cent of gross unsecured consumer credit lending.\(^4^4^4\)

511. The OFT considers that any degree of price competition which does act on the MMF MIF and MSCs is residual and insufficient to justify a finding of non-appreciability.

CONCLUSION ON THE APPLICATION OF ARTICLE 81(1) AND THE CHAPTER I PROHIBITION TO THE COLLECTIVE PRICE RESTRICTION

512. Having carefully considered the representations and submissions received in the administrative procedure preceding this decision, the OFT remains of the view that the collective price restriction contained in the MMF MIF agreement restricts competition in the common market (for the purposes of Article 81(1)) and within the UK (for the purposes of the Chapter I prohibition). Accordingly, it must be considered whether this restriction meets the conditions for exemption contained in Article 81(3) and section 9 of the CA98.

THE APPLICATION OF ARTICLE 81(3) AND SECTION 9 OF THE CA98 TO THE COLLECTIVE PRICE RESTRICTION

513. An agreement which restricts competition but satisfies all of the cumulative exemption criteria in Article 81(3) and section 9 of the CA98 will not infringe Article 81 or the Chapter I prohibition. These cumulative criteria are that an agreement:

(i) contributes to improving production or distribution or promoting technical or economic progress;

(ii) allows consumers a fair share of the resulting benefit;

(iii) does not impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; and

(iv) does not afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in question.

514. In the remainder of this Decision, the cumulative exemption criteria in Article 81(3) and section 9 of the CA98 are referred to as 'exemption conditions' and an agreement which meets all exemption conditions is referred to as an 'exempt agreement'.

515. The case law of the European Court makes clear that an agreement only meets the exemption conditions if it is demonstrated that it brings

\(^{4^4^4}\) Page 21, Mintel, *Credit and Debit Cards*, Finance Intelligence (July 2004).
appreciable objective benefits of such a character as to compensate for the detriments to competition caused by the agreement.\textsuperscript{445}

516. The Parties bear the burden of proving that the MMF MIF agreement meets the exemption conditions.\textsuperscript{446} Whether the MMF MIF agreement insofar as it gives rise to the collective price restriction meets each of the exemption conditions is considered in further detail below.

517. To make the assessment of whether the exemption conditions are met in relation to the collective price restriction, it is necessary to compare the present situation with the MMF MIF to the counterfactual without the MMF MIF agreement. In the absence of a collective agreement it is likely that interchange fees would be set by bilateral agreements between issuers and acquirers.

518. In this Decision, analysis of the third exemption condition precedes analysis of the second exemption condition. This is because analysis of whether a fair share of benefits passes to consumers requires weighing up the negative and positive effects on consumers, but the effects of restrictions which fail the test of indispensability are discounted (as they are anyway prohibited by Article 81 and the Chapter I prohibition).\textsuperscript{447}

Summary of the OFT’s findings on the application of Article 81(3) and section 9 of the CA98 to the collective price restriction

519. The OFT finds that insofar as the MMF MIF agreement gives rise to the collective price restriction it does not satisfy all of the exemption conditions (which the Parties bear the burden of demonstrating are satisfied). The OFT is prepared to accept that a multilateral agreement between issuers and acquirers which only brought within its scope ‘payment transmission services’\textsuperscript{448} (and thus sought to allocate between the parties on a collective basis the costs – and only those costs – associated with such services) could satisfy all exemption conditions. However, the MMF MIF goes beyond this and involves multilateral agreement on non-payment transmission services (‘extraneous services’\textsuperscript{449}). This wider restrictive agreement is not indispensable to the attainment of the benefits which may arise from (more limited) collective agreement. The effect of this is that the MMF MIF exceeds payment transmission costs and is set with reference to (and used to recover) extraneous costs. Therefore, the collective price restriction contained in the MMF MIF agreement does not meet all exemption conditions (specifically, it does not meet the third or second exemption conditions). It follows that the MMF MIF agreement cannot be an exempt agreement.


\textsuperscript{446} Article 2, Modernisation Regulation and section 9(2) of the CA98.

\textsuperscript{447} See paragraph 39 of the Article 81(3) Notice.

\textsuperscript{448} See paragraph 526 below.

\textsuperscript{449} See paragraph 526 below.
First exemption condition: Contributes to improving production or
distribution, or promoting technical or economic progress

520. According to the first exemption condition in Article 81(3), a restrictive
agreement must contribute to improving the production or distribution of
goods or to promoting technical or economic progress. The wording of
section 9(1) is similar to that of Article 81(3) except that in the first
condition in section 9(1) the words “of goods” are not included.

521. The omission of this phrase is intended to make clear (consistent with the
practice of the Commission in relation to Article 81(3)) that improvements
in production or distribution in relation to services may also satisfy the
first condition in section 9(1). The Commission’s practice has been either
to apply Article 81(3) to services by analogy, or to invoke the promotion
of technical and economic progress provision in Article 81(3) in relation to
services agreements.450

The existence of the MMF MIF

522. A feature of the MasterCard scheme is the universal acceptance of all
MasterCard cards by merchants irrespective of the identity of the
cardholder or issuer. This universal acceptance arises from the honour all
cards rule.

523. As stated in paragraphs 398-407 above, the OFT considers that it would
be possible for issuers and acquirers to determine applicable interchange
fees by bilateral agreements rather than the MMF MIF even with the
honour all cards rule. It also considers that arbitration would be a viable
alternative fallback mechanism to the MMF MIF. However, there are
benefits flowing from the MMF MIF which satisfy the first condition and
which would not be realised if issuers and acquirers entered into bilateral
agreements setting interchange fees.

524. The benefits which have been shown to flow from the MMF MIF
agreement can be summarised as:

(i) preventing incumbent issuers and acquirers from ‘holding up’
would-be new entrants from providing payment transmission
services by declining to agree an acceptable interchange fee with
them, so forcing them to resort to arbitration; and

(ii) reducing transactions costs as compared to a situation where all
issuer and acquirer pairs had to conclude bilateral agreements to
set interchange fees, either through negotiation or arbitration, in
order to provide payment transmission services.

525. These benefits are explained in further detail below (see paragraphs 528-
531 below). However, in order fully to explain these benefits it is first

450 Paragraph 5.4, Agreements and concerted practices OFT401 (December 2004) and
paragraph 48 of the Commission Notice Guidelines on the application of Article 81(3) of
helpful to explain various terms which the OFT employs in the remainder of this Decision.

'PAYMENT TRANSMISSION SERVICES', 'PAYMENT TRANSMISSION COSTS', 'EXTRANEOUS SERVICES' AND 'EXTRANEOUS COSTS'

526. In any four-party payment card scheme, there are certain services that are integral to the scheme’s operation as a viable payment transmission mechanism. The OFT refers to these services as 'payment transmission services' and the costs of providing them as 'payment transmission costs'. In addition to providing payment transmission services, issuers participating in the MasterCard scheme provide a number of additional services and recover the costs of these through the MMF MIF. These services, for example the provision of an interest-free period, are not necessary to the operation of a scheme as a payment transmission mechanism. The OFT refers to these services as 'extraneous services' and to the costs of providing them as 'extraneous costs'.

527. The payment transmission services provided to a cardholder and payment transmission services provided to a merchant are in a certain sense strict complements. That is, these two services each have no value without the corresponding complementary service. Payment transmission services provided to a merchant are worthless unless payment transmission services are also provided to the cardholder and vice versa. However, this strict complementarity is restricted to the payment transmission services element of the credit card offering and does not extend to extraneous services to the payment transmission mechanism.451

528. Without the MMF MIF agreement, the honour all cards rule might confer a degree of market power on incumbents. This is because in the specified counterfactual,452 given that the payment transmission services provided by issuers and acquirers are strict complements, any new acquirer would need to reach a bilateral agreement with all existing issuers, and any new issuer would need to reach agreement with all existing acquirers, in order to enter the MasterCard scheme and provide payment transmission services. In this situation, it would be possible for incumbent issuers and acquirers to set interchange fees at a level so as to exploit this monopoly or monopsony power over new entrants. Incumbent issuers could set an interchange fee higher in agreements with new acquirers, and incumbent acquirers could set the fee lower in agreements with new issuers, than would be the case with the MMF MIF. The ability of incumbents to 'hold up' new entry by declining to agree an interchange fee with new entrants (in which case, no interchange fee would apply pending arbitration) would tend to deter new entry overall.453 The absence of a MIF could create uncertainty for new entrants in relation to:

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451 See paragraph 595 below.
452 In which, absent bilateral agreement and pending arbitration, there would be no default interchange fee applying to transactions between issuers and acquirers – see paragraph 398 above.
453 See paragraph 79, Visa MIF decision.
(i) the merits of participating in the MasterCard scheme (because, prior to entry, they will not know the amount of the interchange fee they will face as a cost or revenue); and

(ii) their ability to participate effectively in the MasterCard scheme (because to complete transactions they must enter bilateral agreements with incumbents - but do not know, prior to entry, whether incumbents will in fact enter agreements or the terms of these agreements).

529. The MMF MIF could curtail such possible exploitation by incumbents in the MasterCard scheme and reduce uncertainty for new entrants, thereby facilitating new entry which could lead to increased intra-scheme competition in the provision of issuing and acquiring services. For example, increased intra-scheme competition in the provision of acquiring services is likely to attract more merchants into the scheme. Increased acceptance by merchants, in turn, attracts more cardholders into the scheme and so, MMF argues, the scheme expands to the benefit of all users.

530. In addition, the OFT recognises that the existence of the MMF MIF avoids the higher transactions costs which, although not making a four-party payment card scheme based on bilateral agreements impracticable, would nevertheless arise if all issuer and acquirer pairs had to conclude bilateral agreements (or complete arbitration) to set interchange fees before being able to provide payment transmission services.

531. The OFT therefore accepts that the existence of a MIF (that is, a multilateral agreement in respect of certain services provided by issuers and acquirers and who bears the cost of those services), although giving rise to the collective price restriction, can provide appreciable objective benefits for the purposes of the first exemption condition. Whether these same benefits could be realised with less detriment to competition than is caused by the MMF MIF agreement is considered below when assessing the collective price restriction against the third and second exemption conditions.

532. No substantive arguments have been made against the OFT’s conclusion that the collective price restriction contained in the MMF MIF agreement would meet the first exemption condition. MMF’s argument that the recovery of extraneous costs through the MMF MIF produces the benefits (or more of the benefits) described in paragraph 529 above are considered below in the OFT’s analysis of whether the third exemption condition is met.
Third exemption condition: Indispensability of the restrictions

Summary

533. According to the third exemption condition, an agreement cannot impose restrictions which are not indispensable to the attainment of the benefits created by that agreement.

534. In assessing whether the MMF MIF agreement meets the third exemption condition, the OFT has considered case law of the European Court, in particular, the judgment of the ECJ in Consten and Grundig.\(^{454}\) It has also considered the Article 81(3) Notice, which states that the third exemption condition implies a two-fold test: (i) a restrictive agreement must be reasonably necessary in order to achieve the first condition benefits; and (ii) the individual restrictions of competition that flow from the agreement must also be reasonably necessary for the attainment of those benefits.\(^{455}\)

535. For this exemption condition to be met the MMF MIF must therefore restrict competition no more than is necessary to achieve the first condition benefits.

536. For the reasons given below, the OFT considers that a MIF at or below the level of payment transmission costs incurred by issuers would achieve these benefits without restricting competition to the same extent as the MMF MIF, which is set with reference to extraneous costs, does.

537. The MMF MIF is determined by reference to the costs of certain services (see paragraphs 45-49 above). The MMF MIF restricts competition by (among other restrictive effects) giving rise to collective agreement between the Parties as to who bears those costs (see paragraph 395 above). It follows that, insofar as it is set with reference to both extraneous costs and payment transmission costs, the MMF MIF restricts competition to a greater extent than a MIF set with reference to payment transmission costs only.

538. The OFT notes that, in theory, network externalities could conceivably mean that a scheme could be more efficient with a MIF which was set at above the level of payment transmission costs.\(^{456}\) Equally, in theory a significantly negative MIF could be optimal. However, theory alone cannot demonstrate the appropriate level of the MIF and particularly, given the important discrepancy between private benefits of card acceptance to individual merchants and total benefits of this to merchants in aggregate – the merchant rivalry externality – there can certainly be no presumption that a MIF set above this level would achieve additional efficiencies. The benefits arising in these circumstances would need to be demonstrated precisely. Putting matters the other way around, it is for the Parties to explain and demonstrate why a four-party payment card scheme with a MIF set not to exceed the level of payment transmission costs would be

\(^{454}\) See paragraphs 347-348, Consten and Grundig.
\(^{455}\) Paragraph 73, Article 81(3) Notice.
\(^{456}\) See paragraphs 372-383 above.
significantly less efficient than the MasterCard scheme, with the MMF MIF set by reference to extraneous costs,\textsuperscript{457} and that those efficiency benefits of the MasterCard scheme outweigh the detriments to competition arising from the recovery of extraneous costs through the MMF MIF.\textsuperscript{458}

539. The Parties have not satisfied the OFT that the MMF MIF does generate such efficiency benefits. Rather, the OFT’s view is that the MMF MIF is being used by the Parties not to balance externalities in order to maximise efficiency but as a vehicle to extract revenues from merchants (and many of their customers) for services that primarily benefit issuers (and some cardholders).\textsuperscript{459}

540. The OFT finds that insofar as extraneous costs are recovered through the MMF MIF, it results in an unjustified restriction of competition (i.e. one which is not reasonably necessary for the attainment of first condition benefits) and that therefore it cannot satisfy the third exemption condition. The reasons for this finding are set out in further detail below.

\textit{The recovery of costs through an interchange fee}

541. Some payment transmission services are provided by issuers and some by acquirers. The associated payment transmission costs must be recovered by issuers and acquirers from merchants and/or cardholders in order for the cost of transactions to be recovered. Two-sided demand, which is a feature common to payment mechanisms, and the pattern of incidence of payment transmission costs mean that it may be most efficient for issuers to recover some or all of their payment transmission costs from acquirers through an interchange fee, or vice versa. Subject to the OFT’s findings in this Decision, it is for the participants in a payment card scheme to decide how payment transmission costs are recovered. In the MasterCard scheme, issuers charge acquirers an interchange fee determined by the MMF MIF agreement (i.e. the MMF MIF). In other payment card schemes, an interchange fee may be charged by acquirers to issuers.\textsuperscript{460} Where (as in the MasterCard scheme) payment transmission costs are recovered from acquirers by issuers through an interchange fee, the OFT considers that only payment transmission costs incurred by issuers should be recovered through that interchange fee (unless objective benefits arising from the recovery of additional costs can be demonstrated\textsuperscript{461}). On this basis, and for the reasons given below, the MMF MIF should not be set with reference to extraneous costs.

\textsuperscript{457} Paragraph 75 of the Article 81(3) Notice.
\textsuperscript{458} Paragraph 55 of the Article 81(3) Notice.
\textsuperscript{459} In this respect, the OFT’s findings are consistent with the findings of the Commission with regard to the upward pressures on the MIF in the unmodified Visa scheme, set out at paragraph 80 of the Visa MIF decision.
\textsuperscript{460} This is the case in the Australian EFTPOS system.
\textsuperscript{461} See paragraph 538 above.
The theoretical analysis of the determination of an efficient MIF

542. In its arguments, MMF relies principally on the analysis by Baxter which was one of the first theoretical analyses to consider the question of the interchange fee.\footnote{462 Baxter, W. F. (1983) 'Bank Interchange of Transactional Paper: Legal and Economic Perspectives', Journal of Law & Economics, 26, 541-588.} This analysis has limitations which are outlined in paragraphs 548-557 and 635-636 below. Baxter argued that as a payment system represents a joint service to cardholders and merchants, the sum of the benefits accruing to cardholders and merchants from an additional card transaction should equal the costs of providing an additional transaction. Baxter noted that this could be achieved if cardholders and merchants are each charged a fee equal to the corresponding marginal benefits of card use and merchant acceptance. However, Baxter pointed out that if they price in this way, it would not necessarily be the case that the competing banks which are providing different issuing and acquiring functions would be able to recover their costs. Therefore, Baxter argues that by setting a MIF that has the effect of, for example, acquiring banks compensating issuing banks for the cost of services provided, efficient prices can be set which will be to the benefit of all members in the network.

543. As noted above, when deciding whether or not to hold or use credit or charge cards, cardholders will make individual decisions which are privately optimal for them, but which may be socially inefficient because they will not take into account the benefits and costs to others. For example, a cardholder might be influenced by cashback or reward points when deciding which means of payment to use for a purchase. Similarly, merchants may make privately optimal but socially inefficient decisions about whether to accept credit and charge cards.\footnote{463 See paragraphs 372-383 above.} From a theoretical economic perspective, a payment network will operate at a theoretically optimal level if the net benefits (i.e. total benefits less total costs to the network as a whole) are maximised.\footnote{464 The OFT notes that maximising ‘social welfare’ (according to some economic yardstick) is not necessarily the same as satisfying the exemption conditions in Article 81(3) or section 9 of the CA98.} Such benefits may exceed the benefits accruing to the individual participants in the network because of the presence of externalities. If individual participants do not take into account these externalities, incentives might be needed to ensure that the usage of the network maximises these net benefits.

544. The recent economic literature in the field of payment card networks recognises the potential for these externalities and highlights that, in principle, a MIF could be set to reach a socially efficient balance of costs and benefits on the two sides of the payment network, balancing card usage and card acceptance. The literature argues that whilst a high MIF would raise MSCs, and may reduce merchant card acceptance, it may also have the effect of reducing cardholder fees and encouraging card usage. A low or negative MIF would have the opposite effects, encouraging merchants’ acceptance and discouraging card use.
545. Recent economic literature accepts the possibility of externalities, but takes a more sophisticated approach than Baxter. Schmalensee (2002) and Wright (2003), for example, find that 'social optimality' is related to balancing the promotion of merchant and cardholder demand and also incorporates differences in demand elasticities.

546. The OFT considers that two important points must be drawn from the economic literature on payment systems. First, it is clear that even with a stipulation of what constitutes 'social welfare', it would be very difficult to determine empirically what a socially optimal MIF is with any degree of certainty, or indeed in which direction (if any) it would differ from zero. This type of empirical analysis has not been attempted in the literature. Second, it is also clear that self-interest will not necessarily lead participants in a payment scheme to set a MIF that approximates the socially optimal level. This is confirmed by Katz (2001), who has examined the economic literature in this area as part of an independent review for the Reserve Bank of Australia. He concluded that a MIF chosen by a rationally self-interested association may be expected to be different from the socially optimal MIF.

547. The OFT acknowledges that on some theoretical models a MIF which exceeds the level of payment transmission costs incurred by issuers might conceivably be 'socially optimal' (according to some notion of what constitutes 'social welfare'). However, the socially optimal level for the MMF MIF cannot be determined a priori by economic theory and, in theory, the 'optimal' MIF may be positive, zero or negative.

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466 Wright, J (2003) 'Pricing in debit and credit card schemes', Economics Letters, 80, 305-309.
467 Social optimality, as defined within these papers, occurs when the MIF balances the additional cardholder demand from a higher MIF and the surplus arising from the additional card usage with participating merchants, with the corresponding decrease in merchant demand from a higher MIF and the surplus lost from a decrease in card acceptance from existing card users.
468 The Parties argument that this difficulty does not alter the reality that the MIF must be determined cannot justify the inclusion of extraneous costs in the MIF.
470 See paragraph 104, Katz, M (2001): “The findings on the relationship between the interchange fee chosen by a rationally self-interested association and the socially optimal interchange fee can be summarised as follows. In general, they can be expected to differ from one another. One source of the divergence is that private parties will respond to merchants’ willingness to accept cards, which may be a poor measure of the overall effects of card acceptance on merchant welfare. Because of this distortion in acceptance incentives, privately optimal interchange fees may promote socially excessive use”.
471 If the MIF were negative, the interchange fee would be paid by issuers to acquirers.
The practical application of these principles to the setting of the MMF MIF

548. In general the theoretical literature on interchange fees does not consider in detail the type of costs that arise in four-party payment card mechanisms. The analysis of interchange fees applies to the cost of the transaction mechanism to acquirers and issuers. For example Rochet and Tirole (2002) state, "‘Payment Card’ is a generic name that includes credit cards, debit cards and charge cards. Since we focus here on the payment activity, these differences are immaterial for our purposes."\(^{472}\) Since the analysis applies equally to debit as to credit cards, implicitly the costs are those of the transaction mechanism and cannot be taken to include the credit aspect of credit cards. Baxter (1983) did explicitly consider whether credit cards constitute two separate businesses: transactions and financing. Baxter’s conclusion was that the transaction and financing aspects were ‘disjoint’ on the basis that “one can readily conceive of a bank-card service that did not offer the extended payment facility. ... it would be possible for banks to render transaction services without providing finance services.”\(^{473}\) It should be noted that in 1983, at the time that Baxter was writing, payment cards which offered transaction services but not an extended payment facility were a relative rarity and therefore a largely hypothetical proposition. With the current widespread use of debit cards this is no longer the case.

549. Therefore there can be no presumption from the theoretical literature that costs that are not part of the payment transmission mechanism should be considered in setting a MIF. Furthermore, according to the theory it would only be by remarkable coincidence that the recovery of any particular category of costs, such as extraneous costs, through a MIF would result in a MIF that balanced the externalities discussed in the theoretical literature.

550. There are further difficulties when translating the theoretical propositions on interchange fees to empirical application. As a general comment, Baxter himself highlights certain limitations of his methodology and, in particular, acknowledges that it would be difficult to apply empirically.\(^{474}\)

551. The Baxter framework uses merchants’ willingness to pay for card acceptance, through the MMF MIF and MSCs, as a measure of the benefits that they enjoy from card acceptance. The implied assumption is that, if merchants do not benefit from accepting credit and charge cards,


\(^{473}\) Baxter (1983), page 582.

\(^{474}\) Baxter (1983), pages 578-579, discusses the difficulties involved in measuring the demand functions required to apply his model in a rigorous manner. He states that “no direct observation of the contours of these demand functions is possible” and instead refers to his own approach as “arm-chair empiricism”. It is also important to recognise that the Baxter model is only a partial analysis which does not consider the impact of a MIF on consumers in general, i.e. including those who do not use credit and charge cards but to whom merchants pass on the cost of the MIF and MSC in higher retail prices.
they will stop accepting them and this will force the MMF MIF down to an efficient level.

552. The OFT does not find this assumption convincing for the following reasons. Merchants accept credit and charge cards in part to gain competitive advantage over others who do not and to avoid competitive disadvantage relative to others who do.\textsuperscript{475} A merchant will accept payment by way of credit and charge cards because he, as an individual merchant, can expect to benefit from increased sales. Consequently, the willingness to pay for card acceptance of individual merchants overstates the aggregate merchant benefits of such acceptance.

553. Even if the MMF MIF were otherwise designed to achieve a payment network which operates at a 'socially optimal' level, it would not be appropriate to examine the sum of the benefits accruing to individual merchants. Some, or possibly all, of the additional sales won by the individual merchant accepting credit and charge cards would be taken from competing merchants.

554. Therefore, from the perspective of merchants overall, the acceptance of credit and charge cards may have little relative effect on total sales. As a result, in summing up the benefits of sales increments to individual merchants, Baxter’s method overstates the benefits of card use to merchants overall. Other things being equal, this method over-estimates the amount of the optimal MIF (the sum of the whole being less than the sum of the parts).\textsuperscript{476} Since the sum of the benefits to individual merchants is greater than the benefits to merchants as a whole, a credit card scheme would not be constrained by the individual decisions of merchants from setting a MIF that is too high and thereby promoting excessive card use.

555. A further point to note is that even if the benefits to merchants were appropriately measured there is little or no reason, from economic theory, to expect that the application of the framework would involve loading a substantial proportion of all issuer costs onto merchants via the MMF MIF (including costs of services such as the provision of credit by issuers to cardholders).

556. For example, the theoretical literature notes that externalities are potentially symmetrical, or two-way. Just as card-accepting merchants benefit to some extent from there being more cardholders, so cardholders benefit from there being more card-accepting merchants. The latter source of external benefits could, in theory, go towards justifying a \textit{negative} MIF, in order to promote, by effective subsidy, the wider acceptance of cards by merchants. The theoretical framework by itself therefore gives little reason to expect even that \textit{all} payment transmission costs should be

\textsuperscript{475} For example, see Wright (2003) and Rochet, JC and Tirole, J (2002). Rochet and Tirole highlight that Baxter assumes that merchants believe that accepting the card does not help in attracting consumers. That is a valid assumption in only very restrictive and unrealistic circumstances.

\textsuperscript{476} See Katz (2001), Part B. MMF has disputed the validity of this point in paragraphs 5.4.79-5.4.91 and Annex 3, Joint written representations on the SR14.
recovered from the merchant side of the market.\textsuperscript{477} Still less does it suggest that merchants should be charged at a rate substantially greater than all payment transmission costs. Therefore, the theoretical literature cannot be used to demonstrate that a MIF, such as the MMF MIF, which is set with reference to extraneous costs meets the third exemption condition.

557. The implication from the theoretical literature is that a MIF set with reference to extraneous costs cannot be assumed to be necessary to achieve any benefits beyond those identified in the analysis of the first exemption condition (see paragraphs 533-540 above). Therefore, since a distinction can be drawn between payment transmission costs and extraneous costs,\textsuperscript{478} for the purposes of assessing whether the third exemption condition is passed the OFT has asked whether the MMF MIF is set by reference to extraneous costs.

**Costs recovered through the MMF MIF**

558. In paragraphs 559-584, the OFT identifies the categories of costs based on which the MMF MIF is calculated by the Parties (and which are recovered through the MMF MIF), and considers which of these categories can properly be treated as payment transmission costs.

**PROCESSING COSTS**

559. Processing and settlement are services integral to the operation of the MasterCard scheme as a payment transmission mechanism. The costs of providing these services are therefore payment transmission costs. Recovery of these costs by the Parties in whole or in part through a MIF (in either direction) may therefore be necessary to achieve the benefits identified at paragraphs 520-532 above. The Commission accepted (in the Visa MIF decision) that the recovery of processing costs through the MMF MIF for cross-border transactions was justified in relation to the Visa scheme.\textsuperscript{479}

**CARD PRODUCTION COSTS**

560. Likewise, the OFT considers that the costs of card production are payment transmission costs. A MasterCard card is integral to the operation of the MasterCard scheme as a payment transmission mechanism.

**STATEMENT PRODUCTION COSTS**

561. There are legal requirements, with regard to statement production under section 78 of the Consumer Credit Act 1974 and the Consumer Credit (Running-Account Credit Information) Regulations 1983. Broadly, an issuer must provide written statements to its cardholders, showing the state of

\textsuperscript{477} For example, where issuers include acquirers’ payment transmission costs in the MIF even though these are not costs which issuers bear.

\textsuperscript{478} See paragraphs 595-600 below.

\textsuperscript{479} Paragraph 85, Visa MIF decision.
their accounts at the end of each interest period during which there has been any movement on the accounts. Since issuers must comply with these legal requirements, the extent to which they do so is provision of a service integral to the operation of the scheme as a payment transmission mechanism and the costs of their doing so are, consequently, payment transmission costs.

PAYMENT GUARANTEE AGAINST FRAUD

562. Fraud is an inherent risk in four-party payment card schemes.\textsuperscript{480} As a counter-measure, issuers incur costs for various activities described by MMF under the heading 'payment guarantee against fraud' for which they are reimbursed through the MMF MIF:

(i) authorisation and referral services;

(ii) fraud reduction measures;

(iii) fraud investigation measures; and

(iv) a guarantee to merchants that they will be reimbursed in certain circumstances for transactions which are made fraudulently.

563. The services referred to at paragraph 562(i)-(iii) are, broadly, measures taken by the issuers to reduce the incidence of fraud to the scheme. In addition, acquirers and merchants may incur the costs of installing systems necessary for various fraud reduction and authorisation measures.

564. The provision of services which seek to limit the extent to which fraud prejudices its effective operation is integral to the operation of the scheme as a payment transmission mechanism.

565. In the absence of protection against fraud, merchants would be exposed to the cost of increased fraud. This would make payment cards a less tenable payment transmission mechanism. The costs of providing the services referred to at paragraph 562(i)-(iii) above are therefore payment transmission costs.\textsuperscript{481}

566. Sharing liability for fraud losses between issuers, acquirers, merchants and cardholders may be an efficient means of providing each of these parties with incentives to reduce the incidence of fraud in a four-party payment card scheme as regards matters within their control. The OFT accepts that fraud prevention is likely to be most effective when all parties have incentives to take steps to reduce the likelihood of fraud.\textsuperscript{482} The OFT therefore considers that the means by which liability for fraud losses are shared between the parties to a four-party card scheme are integral to the

\textsuperscript{480} Three-party payment card networks, and other payment mechanisms such as cheques or cash, also have fraud risk and fraud control costs.

\textsuperscript{481} [REDACTED].

\textsuperscript{482} See paragraph 5.5.60, Joint written representations on the SR14.
operation of that scheme as a payment transmission mechanism. It follows that the associated costs are payment transmission costs.

567. In the MasterCard scheme, liability for fraudulent transactions is shared amongst the parties involved:

(i) Under chargeback procedures, an acquirer or (ultimately) a merchant may be charged for a fraudulent transaction.

(ii) Although mostly the cardholder does not bear liability for fraudulent transactions made using his or her card, under certain circumstances the cardholder may be liable for at least a proportion of such fraud losses.

(iii) According to the MCI Rules, losses arising from the use of 'Identified Counterfeit Cards' are generally the responsibility of the issuer, while losses from use of 'Unidentified Counterfeit Cards' are generally the responsibility of the acquirer. However, MMF states that, because of the operation of the fraud guarantee, issuers are liable for fraudulent transactions in face-to-face situations.

568. The guarantee element of the payment guarantee against fraud (as referred to at paragraph 562(iv) above) is therefore one of several means by which liability for fraud losses is shared between the parties to the MasterCard scheme. As a result, it is appropriate to view the cost of the guarantee as a payment transmission cost.

569. The OFT initially considered that it was not indispensable for all of these services covered by the payment guarantee against fraud to be provided only by the scheme and charged for through the MMF MIF. In particular, the OFT considered, at that time, that a less restrictive way of ensuring that the first condition benefits were realised would have been for these services to be allowed to be provided by third parties as an alternative to the scheme or, in respect of the 'guarantee' element, for merchants to be free to decide to self-insure against the risk of fraud. An unbundled arrangement was thought likely to enhance merchants' incentives to reduce fraud and lower the cost base: if the fee that each merchant paid was related to their risk profile, it was thought that there

483 See chapter 6 of the UK Domestic Rules, chapter 10 of the MCE Rules and rule 9.04, chapter 14 and rule 22.06 of the MCI Rules.

484 For example, depending on the precise terms on which the card is issued, the cardholder may be liable for the first £50 of losses attributable to fraud committed by someone using the card after he or she has lost it and he or she may be liable, to any extent, for losses resulting from fraudulent use of the card by someone who acquired possession of it with the cardholder's consent (see sections 83 and 84 of the Consumer Credit Act 1974).

485 See rule 14.02 of the MCI Rules. Rule 14.02(a) provides that, “[REDACTED].”

486 Paragraph 5.5.58, Joint written representations on the SR14.

487 The BRC also submitted that there are a number of totally separate components to the cost of payment guarantee against fraud, and that merchants should not contribute to costs which reflect weaknesses in issuers systems which merchants cannot control (Paragraph 43, BRC submission (3 February 2005)).
would be stronger incentives for merchants to minimise fraud as much as possible. The OFT has, however, been persuaded that “...[s]eparating out the responsibility for fraud losses from fraud prevention would allocate these two functions between two or more parties making it significantly more difficult to minimise the total costs of fraud” and that, therefore, unbundling of responsibility for fraud losses and fraud prevention is not viable. Accordingly, the OFT accepts that these costs are not extraneous costs.

INTEREST-FREE PERIOD

570. The provision of interest-free credit in the form of an interest-free period is not integral to the operation of a four-party payment card scheme as a payment transmission mechanism. The OFT notes that debit card schemes do not provide an interest-free period.

571. In addition, many cardholders do not in practice benefit from an interest-free period. This is because a cardholder who does not repay his or her balance in full at the end of the statement period is generally charged interest on the outstanding transactions from the date that they were made. A large proportion of accounts are not settled in full and therefore do not involve the provision of any interest-free credit. In some other cases, the credit card does not provide interest-free credit under any circumstances.

572. Where interest-free credit is offered, different issuers offer different interest-free periods. Since the provision of an interest-free period is not integral to the operation of a four-party payment card scheme as a payment transmission mechanism, the cost of funding any interest-free period cannot be regarded as a payment transmission cost.

PAYMENT GUARANTEE AGAINST DEFAULT

573. The OFT accepts that all payment mechanisms, except cash, have some risk of default. This risk arises because there is frequently a delay between the time a card (or a cheque) is presented for a transaction and the time the transaction is presented to the issuer. The issuer is therefore not always able to verify at the time of transaction whether the account holder has sufficient funds available in his or her account and to earmark those funds. When the payment is presented to the issuer after the transaction, the account holder may have insufficient funds in his or her account or may have exceeded his or her credit limit.

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488 Paragraph 5.5.70, Joint written representations on the SR14.
489 See paragraph 13 above.
490 By way of example, Mintel reports that Lloyds TSB offers a credit card on which there is no interest-free period which charges a lower APR than its standard rate: page 34, Mintel, *Credit and Debit Cards*, Finance Intelligence (July 2002); page 59, *Moneyfacts* (June 2005) – Lloyds TSB Advance MasterCard card.
491 The interest-free period for a number of MasterCard credit cards is given at pages 58-61, *Moneyfacts* (June 2005). This varies between zero and 59 days.
492 Or sufficient available authorised credit in the case of a credit or charge card.
574. In the MasterCard scheme, the issuer guarantees to pay to the acquirer the funds for those transactions where the credit limit has been breached and therefore is committed to the involuntary extension of credit to these cardholders. These transactions may be avoided or reduced in number through the use of online authorisation, so that funds may be earmarked at the time of transaction, or the transaction may be refused if the funds are not available. The costs of this online authorisation may be borne by acquirers, merchants or issuers but, as a component of processing costs, they would be payment transmission costs.

575. Some involuntary extension of credit is inherent to any four-party payment card scheme which, like the MasterCard scheme, does not have online authorisation of all transactions. This will be true of most debit cards schemes as well as credit card schemes. The means by which losses resulting from such extension of credit (or, alternatively, the costs of ‘transactional default’) are shared between the parties to such a scheme are integral to the operation of that scheme as a payment transmission mechanism and the associated costs are payment transmission costs. It follows that, for the MasterCard scheme, the costs of those elements of the payment guarantee against default which protect against ‘transactional default’ are payment transmission costs.

576. However, the MMF MIF is currently set with reference to a much wider set of issuer costs. It is set with respect to the costs of default arising from voluntary extension of credit, including default after a debt has begun to incur interest (and even after some repayment of interest or principal has been made).

577. Voluntary extension of credit is not integral to the operation of the MasterCard scheme as a payment transmission mechanism. The costs associated with this voluntary extension of credit to cardholders, including the costs of those cardholders defaulting on monthly payments with respect to the agreed extended credit facility, cannot be regarded as payment transmission costs.

The recovery of payment transmission costs through the MMF MIF

578. There are inherent difficulties in judging where the MMF MIF leading to the most efficient recovery of costs lies within the range between (i) a MIF recovering all payment transmission costs of issuers from acquirers; and (ii) a MIF recovering all payment transmission costs of acquirers from issuers. Accordingly, the OFT considers that a MIF agreement entailing discretion for the Parties to set a MIF within the range between (i) and (ii) would be the least restrictive acceptable means of achieving the benefits identified in paragraphs 520-532 above. Such a MIF agreement would therefore meet the third exemption condition, as it would not restrict competition any more than necessary to achieve both of the benefits identified by the OFT in its first exemption condition analysis.

The recovery of extraneous costs through the MMF MIF
579. The OFT considers that (i) the cost of the interest-free period; and (ii) any cost of the payment guarantee against cardholder default which exceeds the costs of transaction default in a four-party payment card system are extraneous costs and their recovery through the MMF MIF means that the MMF MIF agreement does not satisfy the third exemption condition.

INTEREST-FREE PERIOD

580. Given that not all merchants currently accept credit and charge cards, the OFT accepts that for each merchant that does, it may be that its sales are higher than if the merchant had chosen not to accept them. But, as explained in paragraph 551-554, it is necessary to look at the position of merchants as a whole and it does not follow that the sales of merchants as a whole are higher as a result of the interest-free period. Whilst each merchant that accepts credit and charge cards might attract some sales that would have gone to others, the Parties have not shown that passing on the cost of this service to merchants through the MMF MIF will necessarily result in a significantly more efficient scheme so as to realise additional objective benefits for the purposes of the first exemption condition, such as are necessary to justify the recovery of these costs through the MMF MIF.

581. There is considerable literature on the potential effects on consumption of different types of payment and credit mechanisms. Professor Michael Katz provided an independent overview of that literature in this area for the Reserve Bank of Australia and concluded that any claims that the use of credit cards leads to a permanent and significant increase in aggregate consumption are ill-founded. It is more likely that instead of raising consumption and output in the economy, the interest-free period is mainly a means of giving cardholders greater flexibility over the timing of their purchases, although there may be some minor output-enhancing effects due to possibly reduced transaction costs. He emphasises that the benefits should not be overstated. The OFT concurs with this view.

582. Even if MMF had shown that reference to the costs of the interest-free period in calculating the MMF MIF (and recovering it accordingly) generates significant efficiencies for the MasterCard scheme as compared to a four-party payment card scheme with a MIF at or below payment transmission costs, it would need to have shown, additionally, that the resulting benefits are sufficient to outweigh the additional restrictive effects which flow from setting the MMF MIF by reference to these extraneous costs in order to demonstrate that the third exemption

493 See Katz (2001), page 11. MMF has cited evidence to support their claims (see paragraphs 5.18-5.29, Joint written representations on the SO; paragraphs 615-625 below). The OFT has considered this evidence in Annex 5 (The University of Westminster Study) of this Decision and has concluded that it shows that credit card borrowing has not led to any discernable increase in either GDP or retail sales in the UK over the past 30 years.
condition is met.⁴⁹⁴ Failing this, there is no justification for requiring merchants – and, ultimately, all their customers – effectively to subsidise the provision of this service.⁴⁹⁵ While benefits may result to a subset of cardholders, who receive the benefit of an interest-free period without having to bear any of the costs of its provision, the Parties have not demonstrated that these benefits outweigh the detriments to other cardholders, merchants (in aggregate) and consumers generally.

PAYMENT GUARANTEE AGAINST DEFAULT

583. The OFT accepts that, in principle, some elements of the payment guarantee against default relate to 'transactional default' and are inherent to any four-party payment card system. However, the additional costs of providing a payment guarantee against default on cardholder debt are not payment transmission costs and therefore should not be funded by merchants and indirectly by consumers at large through the MMF MIF.⁴⁹⁶

584. As with the 'interest-free period', the Parties have not shown that passing on the cost of this service to merchants through the MMF MIF will necessarily result in a significantly more efficient scheme so as to realise additional benefits for the purposes of the first exemption condition and justify the recovery of these costs through the MIF. There is therefore no justification for the totality of the costs of default being agreed collectively through the MMF MIF and charged to merchants. A MIF which did not enable recovery of these costs would achieve the first exemption condition benefits which the OFT has identified above by a less restrictive means.

Conclusion

585. The MMF MIF is higher than is reasonably necessary to secure all of the benefits identified under the first condition because it leads to recovery from one side of the transaction – the merchant side – of more than all payment transmission costs. The MMF MIF at this level is not indispensable.⁴⁹⁷

586. The MMF MIF would, if set without reference to extraneous costs, achieve all of the first exemption condition benefits which the OFT has identified above by a less restrictive means than a MIF through which extraneous costs are recovered. The Parties have not demonstrated that objective benefits arise from the recovery of extraneous costs through the MMF MIF, nor have they shown that a MIF set without reference to extraneous costs would result in a significantly less efficient four-party payment card scheme than is the case with the MMF MIF.⁴⁹⁸

⁴⁹⁴ In relation to the detriments resulting from setting the MIF by reference to extraneous costs, see paragraphs 652-655 and 681-694 below.
⁴⁹⁵ This was also the conclusion reached in the Cruickshank Report, see in particular paragraph D3.91.
⁴⁹⁶ See paragraph 575 above.
⁴⁹⁷ See paragraph 537 above.
⁴⁹⁸ See paragraphs 538-540 above. See also paragraph 75 of the Article 81(3) Notice.
587. A summary of arguments made against the OFT’s analysis of whether the third exemption condition is satisfied is set out below, together with the OFT’s response. The OFT has carefully considered these arguments but remains of the view that the third exemption condition is not met.

**Distinction between payment transmission costs and extraneous costs**

**SUMMARY OF ARGUMENTS MADE**

588. MMF\(^{499}\) and RBSG\(^{500}\) argue that there is no credible basis for distinguishing between payment transmission costs and extraneous costs, and therefore the OFT’s distinction between payment transmission costs and extraneous costs cannot stand.\(^ {501}\) The OFT has not provided a rational basis for the distinction between payment transmission costs and extraneous costs. All features of the scheme combine to achieve the end result; they are necessarily “...joint and indivisible.”\(^ {502}\)

589. The costs of features of the MasterCard scheme cannot be segmented because: “...it is not conceptually possible to isolate one feature of the product (e.g. the provision of an interest free period) and conclude that that aspect arises solely out of bilateral arrangements with cardholders to which the merchant is indifferent and from which it derives no benefit.”\(^ {503}\) Merchants accept MasterCard credit cards because the features of this payment method provide benefits including (i) near immediate payment for sales; (ii) a comprehensive guarantee against fraud and cardholder default; and (iii) increased sales. Therefore, merchants should contribute to the costs of all features of the MasterCard scheme. In addition, MMF argues that there is complete interdependence and strict complementarity between the activities of issuers and acquirers that benefit cardholders and the activities of issuers and acquirers that benefit merchants.

590. In particular, MMF argues that the correct test for determining whether a cardholder or merchant should contribute to a cost of the MasterCard scheme is whether it relates to a feature of the scheme which delivers benefits to them. Cardholders would purchase less and would not receive the same benefits from MasterCard transactions if the MasterCard scheme did not provide, for example, an interest-free period. Merchants benefit from all features of the MasterCard scheme, including those features which the OFT regards as a source of extraneous costs. Therefore, cardholders and merchants should contribute to the costs of all features of the scheme.

591. Specifically, the payment guarantee and interest-free period are features which are inherent to the MasterCard scheme and fundamental to the benefits that participation in the scheme provides to merchants and

\(^{499}\) Paragraphs 4.131-4.148, Joint written representations on the SO.

\(^{500}\) Paragraphs 3.1-3.9, RBSG written representations on the SO.

\(^{501}\) Paragraph 4.131-4.154 and 5.15 – 5.29, Joint written representations on the SO.

\(^{502}\) Paragraph 4.150, Joint written representations on the SO.

\(^{503}\) Paragraph 4.161, Joint written representations on the SO.
cardholders.\textsuperscript{504} The features of the scheme cannot be unbundled without reducing or eliminating the benefits identified by the OFT in its analysis of the first exemption condition.

592. MMF considers the presence of joint demand for credit and charge card transactions implies that all costs incurred by issuers and acquirers are joint costs and may be recovered through the MMF MIF. For example, if an issuer of MasterCard branded cards were to choose to offer travel insurance to its credit or charge cardholders the costs of providing such travel insurance would be a joint cost to the MasterCard scheme.\textsuperscript{505} As such the cost of travel insurance would be an appropriate cost to refer to in calculating the MMF MIF (although MMF has made clear that it does not calculate the MMF MIF with reference to the costs of travel insurance provided by issuers).

593. The principal benefit to merchants of the MasterCard scheme is “the opportunity to make greater sales than would arise if the merchant did not accept MasterCard”, arising primarily from the ability of merchants to offer “…customers the opportunity to settle on deferred payment terms, without having to assess the customer’s creditworthiness.”\textsuperscript{506}

594. MMF states that if the OFT accepts that merchants benefit from features of the MasterCard scheme which are not integral to payment from cardholders to merchants, but considers that merchants cannot be charged for the costs of these features, then this is inconsistent with:

- the findings of the ECJ in \textit{Bally}\textsuperscript{507}, referred to and approved by the Commission in its \textit{Visa-MIF} decision;

- the findings of the Court of Appeal in \textit{Commissioners of Customs & Excise v Diners Club and another}\textsuperscript{508}; and

- the OFT’s own submissions, and the findings of the High Court, in \textit{OFT v Lloyds TSB and others}\textsuperscript{509}.

THE OFT’S RESPONSE

595. The OFT recognises that payment transmission services provided to a cardholder and payment transmission services provided to a merchant are strict complements (i.e. the former has no value without the latter, and vice versa). However, the Parties have argued that strict complementarity applies to financing services because the option for the cardholder to use financing services in respect of a transaction cannot be provided without a

\textsuperscript{504} Paragraph 5.3.22, Joint written representations on the SR14.

\textsuperscript{505} Mr Carl Munson: pages 84-85, Transcript of joint oral representations on the SO (2 March 2005)

\textsuperscript{506} Paragraph 4.136, Joint written representations on the SO.

\textsuperscript{507} Case C-18/92 [1993] ECR I-2871 at paragraph 9.

\textsuperscript{508} [1989] 2 All ER 385.

\textsuperscript{509} [2004] EWHC 2600 (Comm).
The OFT does not agree. First, in general terms it is quite possible for credit and financing services to be offered in the form of a personal loan or overdraft without being directly attached to use of a particular payment card. Secondly, even if it were accepted that the financing services specifically associated with credit cards would not be provided without a merchant accepting a card, this is a qualitatively different situation to one of strict complementarity. This is because the reverse does not hold: a merchant can be provided with payment transmission services without the cardholder being offered an option for credit.

Where either product is worthless without the other and each product is supplied to a different consumer then it is appropriate to see those consumers having a joint demand for those products. In this context, the OFT takes the view that cardholders and merchants may be considered to have a joint demand for payment transmission services, since the payment transmission services provided to merchants and to cardholders are strict complements, but this joint demand does not apply to additional services that are not integral to the payment transmission mechanism.

The OFT does not accept the Parties' argument that joint demand implies that all costs incurred by the issuer and acquirer, including for example travel insurance offered to a cardholder, are joint costs. The services that are integral to the payment transmission mechanism are strict complements but other services are not. If any joint costs were to arise from the joint demand of cardholders and merchants, these would be limited to the costs of those payment transmission services. It is possible that some additional services, beyond payment transmission services, provided to a cardholder may increase the value of the payment transmission mechanism provided to the merchant and vice versa (i.e. there may be demand externalities in either direction). However the existence of such demand externalities is an empirical question.

In addition, the OFT's distinction between payment transmission costs and extraneous costs is both sustainable and analytically correct. As noted in paragraphs 169-170 above, the OFT does not find that there is a single MasterCard product. Instead, what is relevant are the distinct services provided to merchants and cardholders. Merchants and cardholders are provided with those payment transmission services. Cardholders are also provided with credit and other services by the card issuer. There is no conceptual difficulty in establishing that there are services that are integral to the payment transmission function and there are services that are extraneous to the payment transmission function. There are four-party

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510 Letter from Jones Day to OFT (25 April 2005).
511 A situation where one product (or group of products) has value supplied independently and a second product has no value unless combined with the first product is different from a situation where neither product has value unless combined with the other. In the one case the second product is effectively an add-on to the first product whereas in the other case both products are essential.
512 See paragraph 527 above.
payment card schemes that do not offer the credit and other additional services offered by issuers of MasterCard credit and charge cards.

599. Where a specific feature of the MasterCard scheme is necessary for the operation of the scheme as a payment transmission mechanism, the OFT considers that the MMF MIF may recover the cost of that feature even from just one side of the transaction. However, the cost of a feature cannot be recovered through the MMF MIF simply because it encourages cardholders to use MasterCard cards, or makes the scheme more attractive to merchants or cardholders, as suggested by MMF.

600. MMF’s classification of all costs as joint costs is inconsistent with the analysis in Baxter (1983) which MMF claims is at the heart of its analysis of interchange fees.\(^{513}\) As noted above in paragraph 548, Baxter considered that the transaction and financing costs components of a credit card were 'disjoint'.

601. MMF refers to findings of the Commission, the European Court and UK courts, and claims that these findings support its assertion that cardholders and merchants should contribute to the costs of all features of the MasterCard scheme. The OFT does not accept that this is so.

602. The Diners Club case, and the earlier decision of the Court of Appeal in Re Charge Card Services Ltd\(^{514}\), provide support for the distinction drawn by the OFT between payment transmission services and extraneous services.

603. Sir Nicolas Browne-Wilkinson VC, giving the judgment of the Court of Appeal in Re Charge Card Services Ltd, stated that credit cards have come to be regarded as substitutes for cash (and are frequently referred to as 'plastic money'). The Court found (in the context of a three-party system)\(^{515}\) that payment by credit card was an absolute, rather than conditional, discharge of the cardholder’s liability to the merchant: “the [merchant] was accepting payment by card in substitution for payment in cash, ie as an unconditional discharge of the price. The [merchant] was accepting the [card company’s] obligation to pay instead of cash from a purchaser...By the underlying scheme, the [card company] had bound the [merchant] to accept the card and had authorised the cardholder to pledge the company’s credit. By the signature of the voucher all parties became bound: the [merchant] was bound to accept the card in payment; the company was bound to pay the [merchant]; and the cardholder was bound to pay the company.” (emphasis added). This analysis led the Court naturally to the conclusions that: (i) the cardholder was liable to pay the card company whether or not the card company had paid the merchant; and (ii) the merchant had no right to look for payment from cardholders in the event that it did not receive payment from the card company. On the latter point, Browne-Wilkinson VC commented, “I reach this conclusion

\(^{514}\) [1988] 3 All ER 702.
\(^{515}\) The reasoning of the Court of Appeal is equally applicable to four-party schemes, as has been acknowledged by MMF (see Footnote 143, Joint written representations on the SO).
with satisfaction since I think it reflects the popular perception of the role of credit cards in modern retail trade as ‘plastic money’.

604. Similarly, in the Diners Club case, Woolf LJ made the following observations: “Re Charge Card Services Ltd...is binding authority that where a card is produced by a cardholder and accepted by a retailer and the cardholder signs the sales voucher the cardholder is unconditionally discharged from liability to pay the retailer the amount of the cost of the goods or services...[W]here the [cardholder] becomes indebted to the retailer on a card being accepted, not only is the liability of the cardholder to the retailer extinguished but so also is the debt, albeit that the debt is replaced by a new debt due from the [cardholder] to [the card company]...[A]ny other result would be...inconsistent with the different obligations which [the cardholder] owes to the retailer before he uses his card to those which he owes to the [card company] under his contract with that company after he has used his card. I need only give one example of the sort of term I mean, and that is the term which provides for interest on late payment. If subsequently one of the situations arise where the [card companies] are entitled to have recourse to the retailer, this is in respect of the indebtedness of the [cardholder] to the [card company] and not the debt, if any, which was owed to the retailer.” (emphasis added).

605. In the Lloyds TSB case, the High Court found as follows: “…Conceptually, the credit agreement, and the transactions financed by credit provided under the credit agreement are two different things…” 516

606. These findings of the Court of Appeal and High Court show that the operation of a credit card as a payment transmission system is separable from its operation as a means for cardholders to defer payment. They acknowledge a clear distinction between two consequences of the merchant accepting a credit card: (i) obligations of the cardholder to the merchant are extinguished; and (ii) different obligations arise for the cardholder, as respects the issuer (in a four-party system).

607. As noted above, MMF relies on these and the other precedents it cites to show that, “merchants benefit from each of the characteristics of the MasterCard product that the OFT regards as extraneous; those characteristics form part of the product offered and supplied to merchants and indeed constitute the reason why merchants take the product. Hence these characteristics are integral to the product and are not in any way extraneous to it.”

608. Whether or not merchants individually benefit from particular characteristics of what MMF terms “the MasterCard product”, such as the interest-free period and the guarantee against cardholder default (insofar as it relates to the voluntary extension of credit), is not a relevant test for whether or not services are integral to the operation of the MasterCard scheme as a payment transmission mechanism. While the OFT recognises that, if there were an externality effect on merchants of the extension of

credit to cardholders, this could, in principle, justify a MIF above the level of payment transmission costs, a pre-condition for the presence of such an externality would be that the credit facility brings benefits to merchants in aggregate, such that a failure to set a MIF above the level of payment transmission costs would lead to a less efficient scheme (see Observations on the Economics of Four-Party Payment Card Schemes at paragraphs 372-383 above). For the reasons explained at paragraphs 548-555 above the OFT has concluded that the extraneous services do not give rise to such benefits to merchants in aggregate and the precedents relied on by MMF do not alter this conclusion.

609. The findings relied on by MMF from the Bally case were not in fact findings of the ECJ. As the judgment makes clear, these were findings of the national court which referred the case to the ECJ for a preliminary ruling, under Article 177 (as it then was, now Article 234) of the EC Treaty. It is not, of course, for the ECJ to determine questions of fact (or questions of national law) under that procedure. In any event, the benefits described in the Bally judgment are primarily benefits to merchants individually rather than collectively.

610. In Re Charge Card Services Ltd., the Court of Appeal identified the benefit to the merchant of accepting credit cards as being the ability to attract custom. As explained at paragraphs 548-555 above, this is, however, a benefit to merchants individually, rather than a benefit to merchants collectively.

611. In Diners Club, the Court of Appeal was considering benefits to merchants for the purpose of ascertaining whether or not the card companies made taxable supplies to merchants under the Value Added Tax Act 1983. It is not clear how far the findings of the Court on these points are relevant outside that context. In any event, the benefits to merchants described by Woolf LJ and Dillon LJ are that credit cards provide a means by which a merchant can increase his business and that they provide a guarantee of payment by the card companies, except in exceptional circumstances described in the contracts. As explained at 548-555 above (and above for Bally and Re Charge Card), these are factors which benefit merchants individually but which (taking into account that guaranteed payment from the card company is, here, the corollary of the extension of credit to the cardholder) are of no substantial benefit to merchants in aggregate.

612. Finally, the ruling of the High Court in Lloyds TSB that four-party credit card schemes give rise to “an arrangement” between merchants and issuers such as to engage connected lender liability under section 75 of

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517 Whereas Woolf LJ states that in the first part of his judgment, describing the operation of the various contracts going to make up the card scheme, that he was “not putting any special meaning on the agreements for the purposes of value added tax but giving effect, as is clearly intended, to the language of both bilateral contracts the schemes operated by each of the taxpayer companies”, no such proviso is entered in the second part of his judgment or in the judgment of Dillon LJ.

518 Survey evidence, which MMF relies on to show that merchants value the payment guarantee, in fact does not support that conclusion. See paragraph 623 below.
the Consumer Credit Act 1974 (CCA) did not involve any finding that merchants \textit{collectively} benefit from the provision of an interest-free period or the guarantee against cardholder default. In looking at “\textit{mutuality}” as one test for whether an arrangement had been made between a merchant and an issuer for the purposes of the CCA, the High Court identified that a merchant benefits from agreeing to accept a credit card, “\textit{in that he obtains custom that he might not otherwise obtain}.”\textsuperscript{519} Again, however, this constitutes a benefit to a merchant individually rather than a benefit that is enjoyed by merchants \textit{collectively}.

\textbf{Evidence on the benefits to merchants of the interest-free period and the extended credit facility}

\textbf{SUMMARY OF ARGUMENTS MADE}

613. The Parties argue that evidence provided (particularly the DotEcon Merchant Study) indicates that merchants:

(i) consider that the provision of an interest-free period to cardholders, together with loyalty schemes, are the main contributors to incremental expenditure by cardholders;

(ii) highly value a payment method that generates the incremental expenditure produced by credit cards and are prepared to pay for this; and

(iii) highly value the near immediate payment feature of credit card transactions and are prepared to pay for this feature.\textsuperscript{520}

614. In addition, MMF states there is evidence that (i) customers with credit cards spend more than customers without them,\textsuperscript{521} and (ii) the MasterCard scheme causes a permanent increase in retail spending which benefits all merchants.\textsuperscript{522} This indicates that the interest-free period increases aggregate consumption and aggregate demand: credit card expenditure does not merely replace other expenditure.\textsuperscript{523}

\textbf{THE OFT’S RESPONSE}

615. The Parties have submitted a variety of evidence to demonstrate that merchants in aggregate benefit from the interest-free period and the extended credit facility. This evidence is considered below.

\textsuperscript{519} [Paragraph 28], The Office of Fair Trading v Lloyds TSB Bank [2004] EWHC 2600.
\textsuperscript{520} Paragraph 4.156, Joint written representations on the SO.
\textsuperscript{521} MEPUK/BDRC merchant survey, October 2001, submitted as part of MMF written representations on the R14 (18 January 2002).
\textsuperscript{522} DotEcon: \textit{Merchant Study}, submitted as part of Joint written representations on the SR14.
\textsuperscript{523} Paragraph 7.3.24, MMF written representations on the R14 (18 January 2002); paragraphs 5.3.45, 5.3.61 and following, Joint written representations on the SR14.
As indicated above the OFT considers that in applying a Baxter analysis an important question is whether credit services increase retail sales, and therefore may benefit merchants in aggregate. The most direct piece of evidence relied on by the Parties to demonstrate this effect was a study conducted at the University of Westminster. This study, which is discussed in more detail in Annex 5 (University of Westminster study) of this Decision, analysed aggregate UK data on a quarterly basis on credit card borrowing, retail sales and GDP from 1971 to 2001. However the results of this study do not in any way support the Parties' contention that credit card borrowing increases either retail sales or GDP. Instead, the study’s results indicate that over the 30 year period there was no discernible effect of credit card borrowing on either retail sales or GDP in the UK.

MMF also refers to a paper by Gross and Souleles, analysing US credit card account data, as evidence that the credit facility increases sales.\footnote{Gross, D and Souleles, N (2002).} \footnote{[REDACTED]} has submitted evidence in the form of study conducted by Oxera of UK credit card account data (‘the Oxera study’)\footnote{[REDACTED]} that is similar to the Gross and Souleles study. These studies are considered in more detail in Annex 3 of this Decision. In general, there are conceptual difficulties in using these studies to provide evidence of a link between the credit facility and increased retail sales. The studies examine whether credit card borrowing increases in response to an increase in the credit limit on the account. There are two difficulties with this. First, an increase in credit card borrowing on an account does not necessarily imply that spending has increased on that account. A cardholder may adapt repayment behaviour in response to a higher credit limit rather than changing spending decisions so an increase in borrowing may indicate that a cardholder has simply readjusted their pattern of payment. Secondly, even if it were demonstrated that spending on a credit card account increased as a result of an increase in the credit limit it does not follow that total spending by that cardholder using all payment methods has increased.

The OFT has considered the Oxera study and Gross and Souleles study in detail and has concluded that there is no evidence in these studies that increased credit limits increase overall cardholder spending. Indeed, the evidence they do contain could even point to a small fall in cardholder spending resulting from increased credit limits. \footnote{[REDACTED]} While in principle some cardholders may benefit from the ability to alter their timing of spending, there is no reason to believe that merchants in aggregate benefit from a more pronounced seasonal pattern to spending.

The OFT does not, therefore, believe that these studies can be relied on as evidence that either the interest-free period or the extended credit facility lead to a permanent increase in retail sales hence benefits to merchants in aggregate.

\footnote{524 Gross, D and Souleles, N (2002).}
\footnote{525 [REDACTED].}
620. MMF also relies on survey evidence of cardholders and merchants. As part of its representations on the R14, MMF provided a cardholder survey commissioned from BMRB.\textsuperscript{526} This survey of 1000 credit cardholders asked cardholders whether they spent more because they have a credit card. \textgreater{} \text{60\%} per cent stated that they did not. \text{21-30\%} per cent stated that they did sometimes and \text{11-20\%} per cent stated that they did often.

621. The OFT does not believe that this evidence can be relied on as evidence that credit card use leads to a permanent increase in aggregate retail sales. First, these responses are what cardholders state they would do and may not reflect actual behaviour (the survey also reveals that \text{REDACTED\%} per cent of cardholders state that they pay off their balance in full every month, while the credit card account data described in the Oxera study indicates that the actual figure is \text{REDACTED\%} per cent). More importantly there is a conceptual problem with the study. As is recognised in the discussion of the Oxera study, a credit card can be used to shift the timing of spending. Therefore, cardholders may indicate that they sometimes or often spend more because they have a card. However, it is also likely that many of them sometimes or often spend less because they have a card. Cardholders were not asked whether this was the case. The finding that a minority of cardholders state that in some months they spend more because they have a card is not inconsistent with the finding of the Oxera study. However that study, which is based upon actual cardholder behaviour, does not show that the credit facility increased overall spending by a cardholder. Therefore the OFT does not accept that this survey evidence can be reliably used to conclude that the credit facility leads to an increase in aggregate sales.

622. MMF has also provided surveys of merchants that it states demonstrate evidence of the benefits to merchants of card acceptance. A general difficulty with these surveys is that they relate to the benefits to individual merchants rather than to merchants in aggregate. To the extent that the benefits identified are related to the expectation that by accepting a card the merchant will gain sales lost by other merchants these benefits do not represent aggregate benefits to merchants. A further difficulty is that the surveys relate to the stated benefits or responses to hypothetical changes rather than actual benefits that merchants are observed to receive.

623. The MMF Merchant Study is considered in detail in Annex 8 of this Decision. However the results of this study do not provide support for the view that merchants value the payment guarantee or the interest-free period. The survey was used to estimate the valuation of certain attributes of a payment card. Separate estimates were produced for 78 merchant groups on the basis that different types of merchants may have different valuations of attributes. However for \textgreater{} \text{80 per cent} of the 78 merchant groups the estimates of the valuation of either a full or a limited payment guarantee were insignificantly different from zero.\textsuperscript{527} In other words it

\textsuperscript{526} Appendix 3 (MEPUK/BMRB long cardholder survey, October 2001) submitted as part of MMF written representations on the R14 (18 January 2002).

\textsuperscript{527} Two sets of estimates were produced, one in which the estimate was constrained to be non-negative and the other in which the estimate was unconstrained. The results
cannot be concluded reliably from these estimates that [REDACTED] the 78 merchant groups value the payment guarantee aspect of the payment card. Similarly in the vast majority of cases it can neither be reliably concluded that merchant groups believe that the interest-free period leads to incremental sales nor be reliably concluded that merchant groups value any incremental sales that a payment card may bring.

624. In conclusion the OFT has found that the most direct available test of the effect of credit card borrowing on retail sales indicates that there is no effect in the UK. Other evidence provided by the Parties either does not directly address the relevant question or otherwise cannot be relied upon to rebut this direct evidence. As a result the Parties have not demonstrated that the interest-free period and extended credit facility do benefit merchants in aggregate. Insofar as the relevant evidence of the Parties demonstrates that certain cardholders benefit from the MMF MIF being calculated by reference to the costs of the interest-free period, the Parties have not shown that these benefits outweigh the detriments to (i) merchants in aggregate and (ii) consumers generally (including other cardholders) that result from the recovery of these extraneous costs through the MMF MIF.

625. Even if, for sake of argument, the interest-free period did boost aggregate consumption, MMF's argument is still flawed in that it assumes that boosting demand for goods and services by consumers will cause a sustainable increase in the output of the economy. This could only be achieved if there was an increase in the supply capacity of the economy. The provision of interest-free credit will, at most, only significantly affect the level of consumer demand in the economy and, at best, have only a very limited effect on the supply capacity of the economy. If macroeconomic (notably monetary) policy succeeds in keeping overall demand in line with capacity, the interest-free period will do nothing to boost demand overall. Any tendency for the provision of the interest-free period to boost demand for goods and services by consumers would have to be offset by, say, higher interest rates than would otherwise be necessary in order to head off the resulting inflationary pressure, and/or would have as its counterpart lower demand from other sources (e.g. business investment). There is no obvious reason to believe that such a shift in the pattern of demand would be desirable.

summarised here are the unconstrained estimates. See Annex 8 of this Decision for a fuller discussion.
Method of setting the MMF MIF

SUMMARY OF ARGUMENTS MADE

626. MMF argues that cardholders and merchants will not use or accept MasterCard cards if the price of a transaction exceeds the value of the benefits of a transaction. Similarly, issuers and acquirers will not supply a service unless they can recover their costs. The costs of activities performed by issuers bears no necessary relationship to the amount that cardholders are prepared to pay and the cost of the activities performed by acquirers bears no necessary relationship to the amount the merchants are prepared to pay. Therefore, a transfer payment between acquirer and issuer is necessary to balance the amount each participant receives with their incidence of costs. This transfer is indispensable to realising the benefits of the MasterCard scheme. MMF states that the OFT’s argument that it is difficult to determine the optimal amount of the MMF MIF ignores the reality that “…a MIF must be determined.”

627. The optimal transfer payment is set as a default interchange fee (i.e. the MMF MIF). MMF argues that the method used to determine the MMF MIF is consistent with the Baxter analysis and includes two key elements of that analysis:

(i) A cost formula is measured based on three heads of cost. These heads represent the costs a merchant would incur if it operated a store card scheme (which has very similar characteristics to a credit card scheme).

(ii) Consideration of market pressures, encouraging the introduction of new technology and other competitive constraints. Therefore, while the methodology used to determine the MMF MIF primarily draws on cost studies, it also draws on competition from other payment methods and the impact which change to the amount of the MMF MIF may have on merchant/cardholder demand.

628. According to MMF, the basic approach used to set the MMF MIF is consistent with broader academic literature on setting interchange fees, which recognises joint product and network effects as key characteristics of credit cards. Although it has been adjusted to account, for example, for possible network effects where additional merchants provide benefits for cardholders and additional cardholders provide benefits for merchants, the Baxter analysis remains central to this basic approach: in essence, interchange fees are optimal where they allow costs to be shared between cardholders and merchants according to the individual benefits they receive.

629. MMF describes the MMF MIF set by this method as optimal in two senses. First, it asserts that a situation in which the MMF MIF exists is preferable.

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528 Paragraph 5.5.9, Joint written representations on the SR14.
529 Paragraph 5.52, Joint written representations on the AO.
530 Paragraph 5.31-5.59, 5.65, Joint written representations on the SO.
to a situation in which it does not. The methodology used to set the level of the MMF MIF is intended to generate more of the benefits which are created by its existence, and the existence of these benefits means that the MIF is 'optimal'. Here MMF relies principally on the theoretical analysis of interchange fees proposed by Baxter (1983). Secondly, MMF asserts that the MMF MIF is set using a method that approximates the theoretical 'optimal' MIF which would maximise the number of transactions made using MasterCard cards and maximise benefits to users of the MasterCard scheme by sharing "...the total costs incurred by issuers and acquirers at the margin ... between any cardholder and merchants in proportion to the value each places on the services received."  

630. MMF claims that the MMF MIF is set at an amount which achieves precisely the benefits identified by the OFT as meeting the first exemption condition, namely that:

(i) it would lead to increased competition in the provision of issuing and acquiring services; and

(ii) it would allow a four-party payment scheme to expand to the benefit of all users.

631. Therefore, MMF states that the OFT’s finding that the MMF MIF agreement does not meet this condition (because the MMF MIF is set with reference to and used to recover extraneous costs) cannot stand.

THE OFT’S RESPONSE

632. The OFT has accepted that a MIF may generate benefits/efficiencies relative to a situation with no MIF and that, in two respects, a MIF can generate benefits which meet the first exemption condition. The OFT also accepts that externalities could, in theory, provide a basis for justifying the MMF MIF being set above (or below) the level of the payment transmission costs. It is for MMF, however, to demonstrate that a MIF set without reference to extraneous costs, and at a level no greater than payment transmission costs, would result in a four-party payment card scheme significantly less efficient than the MasterCard scheme with the MMF MIF. MMF has not done this.

633. MMF’s argument is that the MMF MIF is set at a level that proxies the optimal MIF. This argument cannot be accepted as grounds for believing that a MIF set without reference to extraneous costs would lead to a significantly less efficient scheme for the following reasons:

(i) As stated above in paragraph 556-557 the theoretical literature does not provide a justification for the setting of the MMF MIF with reference to extraneous costs. Moreover, a MIF set according to the willingness to pay of individual merchants cannot be expected to lead to an optimal level in the presence of the merchant rivalry

531 Paragraphs 5.36-5.37, Joint written representations on the SO.
532 Paragraph 5.40, Joint written representations on the SO.
externality discussed at paragraphs 538. MMF’s own evidence indicates that card acceptance can lead a significant number of cardholders to switch merchants and that therefore the merchant rivalry externality is not merely a theoretical possibility.\(^533\)

(ii) There are serious flaws in the methodology underpinning the empirical EDC Baxter analysis which MMF relies on to argue that the current MIF approximates the optimal MIF.

(iii) The Parties have not demonstrated that the theoretical literature on the MMF MIF and in particular the Baxter framework did influence the setting of the MMF MIF historically,\(^534\) and is not merely being used by the Parties as a way of seeking to justify the MMF MIF ex post.

634. Point (ii) is elaborated on below.

The flawed EDC Baxter analysis

635. The EDC Baxter analysis purports to show that the optimal interchange fee flows from acquirers to issuers and that the MMF MIF is an appropriate proxy for the optimal level.\(^535\) This analysis used costs from [REDACTED] over a 12-month period to represent both acquiring and issuing activity in the whole UK market.\(^536\)

636. Notwithstanding the OFT’s reservations over the use of the Baxter framework set out above, the OFT does not consider that the methodology underpinning the EDC Baxter analysis is consistent even with Baxter’s theoretical premise. The OFT’s detailed consideration of this analysis is set out in Annex 11 (The EDC Baxter analysis) of this Decision.

The MMF MIF must be set by reference to competitive constraints

SUMMARY OF ARGUMENTS MADE

637. The OFT fails to recognise the freedom to set the MMF MIF is indispensable to the scheme, as any outcome that fettered this freedom would place the scheme at a competitive disadvantage.\(^537\) The MMF MIF must be set by reference to competition provided by other payment card schemes (particularly the Visa scheme). The MasterCard scheme must be

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\(^{533}\) See paragraphs 286-288 above.

\(^{534}\) Both since the adoption of UK domestic rates in 1995 and prior to 1995 when, in the absence of an agreed interchange fee, the MCI International fallback rate applied. Paragraph 3.2, Letter from Denton Wilde Sapte to the OFT (21 March 2002).

\(^{535}\) Paragraphs 5.49-5.50, Joint written representations on the SO.

\(^{536}\) A further draft report *UK Credit Card Market Review (Baxter Analysis), Draft Report (September 2002)* prepared by EDC has been supplied to the OFT by the Parties. This report used a wider sample of issuers and acquirers than was used in compiling the first report. However, the methodology used in the two reports was identical and the flaws identified in the previous study by the OFT also apply to this more recent study.

\(^{537}\) Paragraph 5.66, Joint written representations on the SO.
able to set, and if necessary vary, the amount of the MMF MIF to respond to competition. Freedom to do this is indispensable to the MasterCard scheme as any limit to its ability to recover overall costs would put the scheme at a severe disadvantage. In addition, the OFT has failed to consider (as it should) whether it would be unworkable, complex or burdensome to devise an alternative approach to determining the MMF MIF. For this further reason, its finding cannot stand. 538

638. [REDACTED] argues that without this freedom, competition would be distorted in favour of the Visa scheme and issuers/acquirers would move to three-party schemes. This would have significant detrimental effects on issuers and acquirers.539

THE OFT’S RESPONSE

639. In essence, this argument suggests that the costs of additional features can legitimately be recovered through the MMF MIF, irrespective of how peripheral these features may be to the completion of a transaction, simply because competing payment card schemes also consider that the recovery of these costs is necessary. On this basis, otherwise unlawful conduct would become lawful if others also engaged in it. The OFT cannot accept this as a justification for the recovery of extraneous costs through the MMF MIF.540 The OFT does not accept that it would be unworkable, complex or burdensome to use an alternative approach to set the MMF MIF. Setting a MIF with reference to the payment transmission costs of issuers simply means that the Parties could only consider a subset of the costs which are considered in setting the MMF MIF.�

**Departure from the Commission’s approach**

SUMMARY OF ARGUMENTS MADE

640. According to MMF, the Commission concludes, in its Visa MIF decision that the costs of providing an interest-free period to cardholders and the costs of the guarantee against cardholder default are not extraneous costs. The OFT cannot depart from the Commission's conclusions in respect of these cost categories without good grounds.541 The OFT’s analysis is insufficient to support its departure from the Commission’s findings that these are not extraneous costs.

641. MMF argues that that the OFT cannot depart from the Commission’s findings that the costs of providing an interest-free period to cardholders and the cost of the payment guarantee against cardholder default were not extraneous costs in the sense that the OFT uses this term.

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538 [REDACTED].
539 [REDACTED].
540 See also Case T-219/99 British Airways v Commission, judgment of 17 December 2003, paragraphs 59 to 73 and the cases there referred to.
541 Paragraphs 5.85-5.90, Joint written representations on the SO.
Visa argues similarly that the OFT has wrongly diverged from the legal and economic analysis adopted by the Commission in the *Visa MIF* decision. Specifically, it states that the OFT cannot depart from the *Visa MIF* decision unless it demonstrates that its findings of fact in the present case differ from those made by the Commission and that these factual differences justify reaching a different conclusion. Visa asserts that the OFT has not demonstrated that this is the case.

**THE OFT’S RESPONSE**

**Interest-free period**

643. In its *Visa MIF* decision, the Commission found the recovery of this cost component in the Visa cross-border MIF to be justifiable. However, it did so expressly on the basis of a finding that the provision of interest-free credit had a beneficial effect on cross-border spending as compared to domestic spending: that is, the Commission found that, while it was not proven that the interest-free period increased total aggregate consumption, recovery of the cost of the interest-free period through the MMF MIF for cross-border purchases could nonetheless be justified because it increased cross-border spending (presumably with an offsetting reduction in domestic spending).

644. While this may be relevant when considering a MIF for cross-border transactions, it is not relevant to consideration of a MIF for domestic transactions. A decision by the OFT that costs of the interest-free period should not be recovered through the MMF MIF for UK domestic transactions would not therefore undermine the effectiveness of the *Visa MIF* decision. Nor was the Commission dealing with a ‘corresponding question’ for the purposes of section 60 of the CA98.

645. The Commission also relied on the interest-free period being of benefit to those merchants with whom cross-border purchases were made. As explained in paragraphs 661-665 below, the OFT’s view is that in order to be satisfied that an agreement brings appreciable objective advantages of such a character as to outweigh the disadvantages to competition resulting from it, it is appropriate to consider the effect more generally on consumers and merchants as a whole. Even focusing just on the users of the scheme, the argument set out in the *Visa MIF* decision implies that some merchants may benefit, but only at the expense of others. As the Commission states correctly, there is no reason to expect that the interest-free period will increase aggregate consumption or otherwise benefit merchants in aggregate. Hence, these observations of the Commission give no reason for expecting that a MIF set by reference to the costs of the interest-free period will achieve additional efficiencies. Therefore, even if the OFT is required to have regard to the Commission’s

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542 Visa submission, (25 February 2005).
543 See paragraph 89, *Visa MIF* decision.
544 See also paragraphs 84-95 above.
545 See also paragraphs 96-116 above.
546 Paragraph 89, *Visa MIF* decision.
approach in assessing the interest-free period, it would not be appropriate for the OFT to follow the Commission’s approach in this respect.

646. For all these reasons, the Commission’s conclusion in the Visa MIF decision (that recovering the cost of the interest-free period through the Visa intra-regional MIF satisfied the exemption conditions) does not mean that the OFT is bound to come to the same conclusion when considering recovery of the extraneous cost through the interest-free period in the MMF MIF.

Payment guarantee costs

647. In the Visa MIF decision, the Commission found the recovery of some of the costs of the guarantee against cardholder default through the Visa cross-border MIF to be justifiable. That it did not allow full recovery of these costs is apparent from paragraph 21 and footnote 16 of the decision. Footnote 16 of the Visa MIF decision states, “As concerns default losses, only losses occurring during the free-funding period are to be included in the MMF MIF cost study.” It is not clear from the Visa MIF decision how these particular default losses are delineated.

648. In any event, the Commission found recovery of the costs attributable to these default losses through the Visa cross-border MIF to be justifiable expressly because: (i) the risk of default is higher in a cross-border context than domestically; (ii) in the absence of a payment guarantee, merchants would have to insure against the possibility of a customer not respecting his card payment; and (iii) such insurance “would be likely to be particularly expensive for cross-border payments”.

649. Therefore, the OFT’s decision that all of the costs of the guarantee against cardholder default should not be recovered through the MMF MIF does not undermine the effectiveness of the Visa MIF decision nor does it mean that the OFT is answering a corresponding question in an inconsistent manner for the purposes of section 60 of the CA98.

\[547\] Paragraphs 86-87, Visa MIF decision.
Second exemption condition: Allowing consumers a fair share of the resulting benefit

650. It follows from the above conclusion on the application of the third exemption condition that the MMF MIF agreement cannot be an exempt agreement. It is not strictly necessary to consider, additionally, the application of the remaining exemption conditions to the collective price restriction. The OFT has done so, however, in order to assist the Parties and others to understand what sort of MIF agreement could satisfy the exemption conditions.

651. According to the second exemption condition consumers must receive a fair share of the first condition benefits generated by the restrictive agreement. The concept of 'consumers' encompasses all direct or indirect users of the products covered by an agreement. Consumers are customers of the parties to the agreement and subsequent purchasers. In determining whether consumers receive a fair share of the benefits generated by the MMF MIF agreement, the OFT has considered the position of consumers generally in addition to that of users of the card payment scheme (i.e. cardholders and merchants).

The recovery through the MMF MIF of payment transmission costs

652. Merchants, cardholders and consumers generally may benefit from a MIF which:

(i) prevents incumbent issuers and acquirers from 'holding up' new entry; and

(ii) reduces transactions costs which would exist where all issuer and acquirer pairs had to conclude bilateral agreements (see paragraphs 520-532 above).

653. Merchants who accept MasterCard cards pass on the costs of the MMF MIF in their retail prices at least to some degree (see paragraphs 194-199 above). Therefore, the OFT considers that the MMF MIF, which is set at a level above payment transmission costs, imposes a 'tax' on merchants in the form of increased MSCs. These are passed on (wholly or in part) to all the merchants' customers, including those who use other payment methods (e.g. cash or cheques) and those who do not use MasterCard cards. These consumers do not receive a fair share of benefits, insofar as the MMF MIF is set unnecessarily high because it is used to recover extraneous costs.

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548 Paragraph 84, Article 81(3) Notice.
549 See paragraph 395 above. Even if merchants who accept MasterCard cards did not pass on (or fully pass on) the MMF MIF in their retail prices, in applying the exemption conditions merchants are 'consumers' in the acquiring market.
654. In order to satisfy the second condition, the MMF MIF would need to be:

(i) calculated not to exceed the sum of the weighted average payment transmission costs incurred by issuers;\textsuperscript{550} and

(ii) independently reviewed on a regular basis to ensure that the MMF MIF does not exceed the sum of the weighted average payment transmission costs incurred by issuers set and to allow variations in the MMF MIF to take account of any reduction in costs due, for example, to improved technology.\textsuperscript{551}

655. The OFT accepts that since the MMF MIF is related to average unit costs there is an incentive for issuers to reduce their costs below this average.\textsuperscript{552} Provided the Parties conduct regular cost studies and adjust the MMF MIF to reflect reductions in average costs, the efficiency gains resulting from these incentives will be passed on to consumers. The merits of this type of benchmark were previously recognised in the Link decision,\textsuperscript{553} and there would be considerable merit in the Parties implementing this approach in the event that the MMF MIF was calculated in the manner described in paragraph 654 above. However given that extraneous costs are recovered through the MMF MIF, these efficiency incentives do not alleviate the OFT’s concerns about the amount of the MMF MIF.

Summary of arguments made against the OFT’s analysis

656. MMF argues that the MMF MIF which is set by reference to (and used to recover) extraneous costs meets the second exemption condition.\textsuperscript{554}

THE OFT’S APPROACH TO ASSESSING CONSUMER BENEFIT

657. MMF argues that the OFT’s approach to assessing whether the MMF MIF agreement generates benefits for consumers is flawed. According to MMF, the Commission’s general approach in assessing consumer benefit is to focus on the benefits arising for the direct customers or users of the product or service in question (cardholders and merchants).

658. It is only in exceptional cases that the Commission has considered society in general in assessing a fair share of benefits. In this instance, MMF contends that clear benefits arise for the direct users of the MasterCard

\textsuperscript{550} If the MMF MIF was negative (i.e. paid by issuers to acquirers), it would need to be calculated not to exceed the sum of the weighted average payment transmission costs incurred by acquirers.

\textsuperscript{551} The OFT recognises that payment transmission costs may rise and that, to the extent that the other requirements are satisfied, it would be justifiable for the Parties to have the discretion to recover these increased costs through the MIF.

\textsuperscript{552} Paragraph 6.3.3, MMF written representations on the R14 (18 January 2002).

\textsuperscript{553} Paragraph 48, case CP/0642/00/S Link Interchange Network Limited, OFT decision of 16 October 2001.

\textsuperscript{554} Paragraphs 5.67-5.83, Joint written representations on the SO.
scheme and there is no indication that consumers in general suffer detriment.

CREDIT CARDS ARE NOT MORE EXPENSIVE THAN OTHER PAYMENT METHODS

659. According to MMF, the OFT fails to provide evidence that credit card payments are generally more expensive than other payment methods. Therefore, there is no reason why merchants' costs would decrease if the MMF MIF, and thus the MSCs charged to merchants, were reduced.

660. All payment methods impose costs on merchants and these costs are recovered through the retail price paid by all customers. Cost averaging (recovering costs of services used by specific customers from all customers) is common in many business activities.\(^\text{555}\) If the absorption of the costs of other payment methods into retail prices is acceptable, then there is no reason for treating credit cards differently. Where the OFT considers the impact of credit cards on consumers generally, then the costs of credit cards should be compared with the costs associated with using cash as a payment method. These costs are likely to be higher than the costs of credit cards.

The OFT's response

THE OFT'S APPROACH TO ASSESSING CONSUMER BENEFIT

661. The OFT does not accept the argument that it is incorrect to focus primarily on consumers in the sense of retail customers in general rather than users of the MasterCard scheme (i.e. merchants and cardholders).\(^\text{556}\)

662. In considering whether consumers receive a fair share of the benefits, the OFT has considered the position not only of users of the card payment scheme (i.e. cardholders and merchants) but also the position of all consumers who make purchases from merchants that accept MasterCard cards.

663. The OFT's approach to the definition of consumers is consistent with that taken by the Commission in its Notice on Cross-Border Credit Transfers, where it stated that "Where...banks introduce multilateral interchange fee arrangements, the Commission (in applying the criteria set out in Article 81(3)) for obtaining exemption) will examine the economic benefit which these arrangements seek to achieve and consider whether consumers (including both those who are customers and those who are not) will receive a fair share of the benefit and whether the particular interchange fee arrangements are actually necessary as a means to achieve that benefit" (emphasis added).\(^\text{557}\) Although the Notice on Cross-Border Credit

\(^{555}\) Paragraphs 5.4.42–5.4.43, Joint written representations on the SR14.

\(^{556}\) Paragraph 5.4.25, Joint written representations on the SR14.

Transfers does not apply to four-party payment card schemes\textsuperscript{558}, it confirms that in a payment systems context 'consumers' should be understood to include consumers in general.

664. The OFT also considers that its approach to the definition of consumers, including all customers of merchants accepting MasterCard credit and charge cards, irrespective of the payment used by the customer, is consistent with that taken by the Commission in the Article 81(3) Notice (paragraph 84). Merchants accepting MasterCard credit and charge cards are direct customers of the acquirers who are parties to the agreement on the MIF. However, merchants do not sell-on the MasterCard acquiring services they receive from acquirers to their customers; instead they use the MasterCard acquiring services as an \textit{input} to enable them to offer merchant services to their customers, some of whom may pay with MasterCard and some of whom may use another form of payment. All customers of merchants are \textit{final consumers} of those merchant services; and in that sense they are all \textit{indirect users} of the MasterCard acquiring services, since these are a general input for the purposes of providing merchant services. (This analysis is supported by the fact that the costs of the MSC are typically spread over all of a merchant's sales.)

665. The direct customers of the MasterCard product are cardholders and merchants. However, in assessing whether the second condition is satisfied, it is appropriate also to consider whether customers (including merchants) receive a fair share of the benefits.\textsuperscript{559} In particular, all customers making purchases at merchants who accept MasterCard credit and charge cards are likely to be confronted with the cost of the MMF MIF irrespective of the form of payment that they use, since the MMF MIF is generally passed on by merchants at least to some degree in the form of higher retail prices.\textsuperscript{560} The Commission recognised this fact in its \textit{Visa MIF} decision but then failed to take into account the effect on such consumers in its Article 81(3) assessment.\textsuperscript{561} The OFT also recognises that, if a MIF is valid.

\textsuperscript{558} Paragraph 4.4.28(d)(iii), Joint written representations on the SR14.

\textsuperscript{559} Even if it is wrong to consider all merchants’ customers, including those who use other payment methods (e.g. cash or cheques), to be indirect users of the services covered by the MMF MIF agreement for the purposes of the Article 81(3) Notice, the OFT considers that, having regard to Commission decisions as required by section 60 of the CA98 (in particular, cases in the environmental field, such as \textit{Philips/Osram} OJ [1994] L378/37; \textit{Exxon/Shell} OJ [1994] L144/20; \textit{Ford/Volkswagen} OJ [1993] L20/14; three cases referred to in the Commission’s XXVIIIth Report on Competition Policy (1998), paragraphs 129-133; as well as the relevant section of the Horizontal Guidelines) it could be argued that, in such a case as this, the OFT ought to consider society in general in applying the second exemption condition. The same could be argued also in relation to cases of the European Court in the media sector, such as \textit{Joined cases T-528/93, T-542/93, T-543/93 and T-546/93, Métropole and others v Commission} [1996] ECR II-649, (see paragraphs 116-121); and Case C-243/83 \textit{Binon & Cie SA v Agence et Messageries de la Presse SA} [1985] ECR 2015, where the ECJ accepted that the public interest in maintaining plurality of the media meant that a system of selective distribution involving the fixing of selling prices was capable of benefiting from an exemption.

\textsuperscript{560} Insofar as merchants are unable to pass on the cost, they would not receive a fair share of the benefits.

\textsuperscript{561} See paragraphs 48, 80 and 92, \textit{Visa MIF} decision.
set at an appropriate level, the scheme will lead to a net benefit to consumers in general (see paragraph 578 above).

CREDIT CARDS ARE NOT MORE EXPENSIVE THAN OTHER PAYMENT METHODS

666. As set out in Annex 4 (Effect of the MMF MIF on retail prices) of this Decision, a lower MSC payable on MasterCard transactions has an unambiguous direct effect of reducing merchants' costs (assuming that the lower resulting MIF was passed through to merchants as a result of competition between acquirers). Under normal competitive conditions, it is reasonable to expect that merchants will pass on the lower marginal costs in the form of lower prices to customers. This is the direct effect of a reduction in the MMF MIF on retail prices. The reduction in the MMF MIF may also have an indirect effect on the payment costs of merchants. If a reduction in the MMF MIF induces some customers to alter their choice of payment method, then, since different payment methods vary in their cost to merchants, a change in the composition of payment methods may change the average transaction cost of merchants. This indirect effect may reinforce the direct effect if, as a result of the reduction in the MMF MIF, customers switch from more expensive to cheaper payment methods. Even if a reduction in the MMF MIF induced consumers to use other more costly payment methods instead of the MasterCard scheme, the indirect effect of such switching would have to outweigh the direct effect for merchants' costs to increase. In many cases the indirect effect would be to further lower merchant costs.

667. The OFT accepts that different payment methods vary in their cost to merchants and that, therefore, a change in the composition of payment methods may alter the average transaction costs of merchants. However, it is likely that a proportion of those customers who would switch payment method as a result of the lower MMF MIF would switch to forms of payment which are less costly to merchants (e.g. debit cards).\textsuperscript{562} For the reasons set out in Annex 4 of this Decision, the OFT considers it highly unlikely that a reduction in the MMF MIF will lead to an increase in the costs of merchants.\textsuperscript{563}

668. As stated in paragraphs 686-688 below, the OFT considers that the MMF MIF set at a level above payment transmission costs imposes a 'tax' on merchants, in the form of an increased MSC, which is passed on to all the merchants' customers, including those who use other payment methods (e.g. cash or cheques) and those who do not use MasterCard cards. Under normal competitive conditions, it is reasonable to expect that merchants

\textsuperscript{562} Interchange fees for credit and charge card transactions can be shown to be much higher on average than those for debit card transactions (see footnote 12 above).
\textsuperscript{563} Indeed, using a variety of scenarios, the only two possible ways that the OFT has identified that this could occur is if a reduction in MIF were to lead to a small reduction in MSC which resulted in either a substantial shift from MasterCard transactions to the more expensive Amex scheme (which is far less widely accepted by merchants) or a substantial shift from cheaper debit card transactions to more expensive credit card (including MasterCard) transactions.
will pass lower marginal costs on to customers. Therefore, following the analysis above, a reduction in the amount of 'tax' imposed by the MMF MIF, passed on to merchants as a reduced MSC, would be expected to ultimately lead to reduced prices for customers.

**Fourth exemption condition: No elimination of competition in respect of a substantial part of the products in question**

669. According to the fourth exemption condition, an agreement must not allow the undertakings involved to eliminate competition in respect of a substantial part of the products concerned. The OFT accepts that the MMF MIF agreement does not eliminate competition in respect of a substantial part of the products in question.

670. In the wholesale market, it does not eliminate competition because individual issuers and acquirers can enter into bilateral agreements on the interchange fees, rather than relying on the MMF MIF which is the default interchange fee applicable in the absence of bilateral agreement. Indeed, the UK Domestic Rules provide that “the scheme encourages members to make reasonable endeavours to agree commercially driven bilateral interchange fees, but in the absence of a Bilateral Interchange Agreement, Domestic Fallback Interchange Fees will apply.”

671. Although the existence of the MMF MIF strongly deters bilateral agreements, it does not entirely eliminate their possibility and bilateral agreements have existed previously. Between 1997 and 1999, a small number of issuers and acquirers participating in the MasterCard scheme had bilateral arrangements for purchase transactions in which the applicable interchange fee was not the MMF MIF.

672. In the issuing market, issuers within the MasterCard scheme are free to, and do, compete on various aspects of the services provided to cardholders, such as, notably, the interest rates charged for extended credit, loyalty and cashback schemes, and the provision of an interest-free period (including competing on the length of the period offered).

673. In the acquiring market, although the MMF MIF is typically a major component of MSCs, there remains some scope for intra-scheme competition between acquirers on the level of MSCs.

674. For these reasons, as regards the collective price restriction, the OFT considers that the MMF MIF agreement satisfies the fourth exemption condition.

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564 Clause 4.6 of the UK Domestic Rules.
565 See paragraphs 42-43 above.
566 See the Commission’s similar conclusion at paragraph 106 of its Visa MIF decision.
567 Paragraph 411 above.
E THE EXTRANEOUS COSTS RESTRICTION

675. In this Section of this Decision the OFT examines:

- the object of the extraneous costs restriction arising from the MMF MIF agreement in terms of Article 81(1) and the Chapter I prohibition;
- the effect of the extraneous costs restriction arising from the MMF MIF agreement in terms of Article 81(1) and the Chapter I prohibition;
- arguments made by the Parties and other persons concerning the OFT’s assessment of the impact on competition of this restriction;
- whether the extraneous costs restriction gives rise to an appreciable restriction of competition in terms of Article 81(1) and the Chapter I prohibition; and
- whether the extraneous restriction satisfies each of the exemption conditions contained in Article 81(3) and section 9 of the CA98.

676. As stated, in this Decision 'restriction of competition' and 'distortion of competition' are used interchangeably and both should be read as meaning an appreciable prevention, restriction and/or distortion of competition in terms of Article 81(1) and the Chapter I prohibition. 'Restricts competition' and 'distorts competition' should be interpreted accordingly.

THE OBJECT OF THE EXTRANEOUS COSTS RESTRICTION

677. As explained in paragraph 526 above, in any four-party payment card scheme there are certain services integral to the scheme’s operation as a viable payment transmission mechanism: 'payment transmission services' in this Decision. The payment transmission services provided by issuers to cardholders, and by acquirers to merchants, are strict complements, in the sense that the payment transmission services provided by issuers to cardholders have no value unless payment transmission services are also provided to merchants and vice versa.

678. Issuers in the MasterCard scheme also, however, provide a number of additional services to cardholders: 'extraneous services' in this Decision. In particular, they provide financing services. Extraneous services are not strict complements in the way that the payment transmission services supplied by issuers are strict complements (see paragraph 595 above).

679. Insofar as the MMF MIF is set with reference to the costs of providing extraneous services (i.e. extraneous costs) then it could be characterised as a price-fixing agreement which has as its object the restriction of competition in the acquiring and issuing markets. This characterisation is possible because the MMF MIF is, in part, a collective agreement that extraneous costs incurred by issuers should be borne by acquirers. The economic context in which the MMF MIF agreement operates means that
these extraneous costs are, in turn, passed on by acquirers to their merchants. In this way, the object of the MMF MIF agreement could be considered to be to extract revenues from merchants for services that primarily benefit issuers (and some cardholders).

680. Since, for the reasons explained below, the OFT finds that the MMF MIF agreement, insofar as it gives rise to this extraneous costs restriction, has the effect of restricting competition, it is not necessary to conclude on whether it also has the object of restricting competition for the purposes of Article 81(1) and the Chapter I prohibition.

EFFECT OF THE EXTRANEOUS COSTS RESTRICTION

681. It is not necessary to incur extraneous costs in order to provide payment transmission services: as just explained, extraneous services are not strict complements with payment transmission services. The MMF MIF agreement has the effect that others are required, by collective agreement of the Parties, to bear the costs of issuers arising from the supply of extraneous services.

682. The recovery of extraneous costs (specifically, the costs of providing an interest-free period and some of the costs of a payment guarantee against default) through the MMF MIF allows these costs to be passed on and recovered from merchants directly (through MSCs which are higher than they would otherwise be), and from consumers indirectly where merchants increase retail prices to recover the costs of MSCs.

683. In its assessment of the extraneous costs restriction, the OFT refers to some analysis contained in its assessment of whether the collective price restriction meets the exemption conditions (in particular, the application of the third exemption condition). However, as noted in paragraph 384 above, the collective price restriction and the extraneous costs restriction are independent restrictions: the OFT has made separate findings in respect of each restriction. As stated above, the OFT considers that both restrictions are established in this Decision. The MMF MIF agreement falls within Article 81(1) and the Chapter I prohibition on the basis of each restriction.

684. The extraneous costs restriction has the following effects on acquiring and issuing which give rise to a restriction of competition.

Acquiring

685. The extraneous costs restriction gives rise to effects in acquiring by causing the MMF MIF to be set with reference to extraneous costs and these costs to be recovered through the MMF MIF. This means that the MMF MIF is higher than it would be without the restriction.

686. A higher MMF MIF represents an increase in a major part of the total costs faced by acquirers. Indeed, the inclusion of extraneous costs in the MMF MIF can be seen as the equivalent of a 'tax' on acquirers. An increase in
the total costs faced by acquirers directly affects the level of MSCs which acquirers charge to merchants as, typically, the costs to acquirers of an inflated MMF MIF are passed on to merchants in the form of higher MSCs (in this way, the 'tax' on acquirers is effectively passed on from acquirers to merchants).\footnote{See paragraphs 201-203 above and Professor von Weizsäcker: page 18, Joint oral representations on the SO.}

As an increase in costs faced by all acquirers, a higher MMF MIF influences both the ability and willingness of acquirers to compete on the amount of MSCs charged to merchants. The recovery of extraneous costs through the MMF MIF uniformly raises the common price floor for the MSCs charged by acquirers to merchants. This common price floor will be independent of the features of the business of individual acquirers. As a result, rather than competing down to the level of the underlying costs of providing a payment transmission mechanism, acquirers face an inflated cost base, including the extraneous costs which are recovered through the MMF MIF. The normal competitive mechanisms that determine prices in a market without restrictions on competition are thus distorted by the presence of extraneous costs.

In turn, merchants will seek to recover the cost of higher MSCs. Unless merchants add a surcharge to the retail price of goods and services bought with MasterCard cards, those customers of merchants who use MasterCard cards as a payment method do not face the cost of these transactions directly.\footnote{See paragraphs 410-414 above. The OFT’s views on the likelihood of merchant surcharging are set out above at paragraphs 284-291.} Instead, it is likely that merchants will recover the higher cost of MSCs through retail prices as a ‘hidden’ cost.\footnote{See paragraphs 194-199 and 653 above.} Where this is done, extraneous costs are ultimately borne by all of that merchant’s customers. In short, the ‘tax’ on merchants resulting from higher MSCs is passed on to all merchants’ customers - including those customers who use other payment methods (e.g. debit cards, cash or cheques) and who do not use MasterCard cards.\footnote{See discussion in Annex 4 of this Decision.} This leads to the benefits that some credit and charge card holders receive (e.g. interest-free periods) being indirectly subsidised by those who use other forms of payment. Although it is likely that merchants will generally pass on the costs of MSCs, detriment to merchants will arise to the extent that higher MSCs generated by a higher MMF MIF cannot be fully passed on to their customers.

### Issuing

The extraneous costs restriction gives rise to effects in issuing by distorting competition between MasterCard scheme issuers for cardholders.\footnote{MCE/ MCI acknowledge that the MIF creates some commonality of costs as regards MSCs and the charges made by issuers to cardholders but argues that, in the absence of} As the Commission found in its Visa MIF decision,
competition between issuers is affected by the MMF MIF because it fixes a significant part of issuer revenues.\textsuperscript{573} Interchange fees are an important source of income for credit card providers, representing on average \textit{between 10 and 25}\textsuperscript{574} per cent of total issuer revenue in the UK. The MMF MIF enables issuers collectively to pass costs, which they incur in respect of their extension of credit to cardholders, on to acquirers, and hence to merchants and their customers.

690. As a consequence, the recovery of extraneous costs through the MMF MIF distorts competition by generating extra interchange revenue for issuers on any transaction made using their cards. This increases the incentives for issuers to provide inducements for cardholders to use MasterCard cards, for example, through loyalty schemes, advertising and funding the provision of an interest-free period. The extra interchange revenue is also an additional source of revenue for issuers that can be used to fund these inducements (insofar as it is not retained by issuers).\textsuperscript{575}

691. MMF has stated that it is legitimate to recover through the MMF MIF costs of \textit{any} feature of the MasterCard scheme which increases the propensity of cardholders to use MasterCard cards.\textsuperscript{576} Although issuers must be free individually to determine what they do with revenue derived from the MMF MIF, the OFT considers that the recovery of extraneous costs through the collectively-set MMF MIF distorts the incentives faced by issuers, as explained above.

692. By acting on these incentives, issuers make the MasterCard scheme more attractive as a payment method (for cardholders and prospective cardholders) than alternatives such as debit cards, cheques or cash.\textsuperscript{577} Accordingly, to the extent that issuers participating in the MasterCard scheme receive revenue derived from the (collectively agreed) MMF MIF and act on the incentives that the MMF MIF provides to issuers to offer inducements to consumers to hold MasterCard credit cards and to use MasterCard credit cards in preference to other payment methods, it results in a distortion of competition in the issuing market because it increases MIF revenue and distorts inter-system competition.

693. The recovery of extraneous costs through the MMF MIF also distorts intra-scheme competition in the issuing market. The MMF MIF, set by reference

\textsuperscript{573} Paragraph 66, \textit{Visa MIF} decision.
\textsuperscript{574} See paragraph 510 above.
\textsuperscript{575} See Annex 7 of this Decision. Datamonitor, \textit{Payment Card Loyalty Schemes} BFFS0279 (April 2004), page 49 notes that: “For example the impact of any reduction in interchange fees in some markets, widely acknowledged as the revenue stream that funds many card loyalty schemes, could have a severe impact on the ability of some issuers to continue to offer programs”.
\textsuperscript{576} Mr Carl Munson: page 86, Transcript of joint oral representations on the SO.
\textsuperscript{577} MMF has stated that it is legitimate to include in the MMF MIF costs of any feature of the MasterCard scheme which increases the propensity of cardholders to use MasterCard cards (see Mr Carl Munson: page 86, Transcript of joint oral representations on the SO).
to extraneous costs, accounts for a substantial proportion of issuer revenue (which is recovered from merchants and their customers). If issuers had instead to recover from cardholders the full costs of extending credit to them, it is likely that they would compete more in relation to the prices they charge to cardholders. It is likely that individual issuers would pursue different methods of recovering extraneous costs as opposed to the uniform approach arising from the MMF MIF agreement: namely that extraneous costs are charged to acquirers through the collectively-set MMF MIF, which is therefore higher than it would otherwise be.

694. In addition, the recovery of extraneous costs through the MMF MIF distorts competition between issuers as a result of their changed incentives as to the categories of consumers upon whom they should focus their competitive behaviour. The extra revenue from a higher MMF MIF means that cardholders who spend more on their MasterCard cards, whether or not they use them for borrowing, are more attractive to issuers than would otherwise be the case. Furthermore, the means available to issuers to attract such cardholders are increased by this extra revenue (by differing amounts, according to the composition of their cardholder base), enabling them to offer inducements that would otherwise have to be funded from another source, if still provided.

REPRESENTATIONS AND SUBMISSIONS ON THE EXTRANEOUS COSTS RESTRICTION IN THE ACQUIRING AND ISSUING MARKETS

695. In this part, the OFT summarises the main arguments made against its finding that the extraneous costs restriction gives rise to a restriction of competition in the acquiring and issuing markets for the purposes of Article 81(1) and the Chapter I prohibition. These arguments are contained in representations made by parties to the notified agreement and submissions made by other persons.

Extraneous costs may be recovered through bilateral interchange fees

Summary of arguments made

696. MMF argues it is likely that extraneous costs would be recovered through bilaterally agreed interchange fees, and therefore that these interchange fees would be no less than the MMF MIF.\(^{578}\) Evidence has been provided to the OFT which indicates that bilaterally agreed interchange fees may exceed the MMF MIF, because of issuers incentives to maximise revenue and the relative bargaining power of issuers and acquirers.

697. MCE argues separately that the counterfactual against which the OFT must assess the extraneous costs restriction is a situation in which interchange fees are set bilaterally: the OFT must examine whether those costs which the OFT asserts are extraneous would be recovered through interchange fees in the absence of the MMF MIF.\(^{579}\) To use the

\(^{578}\) Paragraphs 4.117-4.124, Joint written representations on the SO.

\(^{579}\) Letter from Jones Day to the OFT (25 April 2005).
counterfactual of a four-party payment card scheme with a MIF which is not set by reference to extraneous costs, and is not used to recover extraneous costs, assumes what the OFT has to prove (that extraneous costs are indeed extraneous).  

**The OFT’s response**

698. The counterfactual against which the OFT has assessed the extraneous costs restriction is a four-party payment card scheme in which the amount of any interchange fee is set multilaterally and does not exceed the level of payment transmission costs incurred by issuers (or acquirers if an interchange fee is negative (i.e. paid from issuers to acquirers)). By using this counterfactual, the OFT is not assuming what it has to prove, given that a clear and natural distinction exists between payment transmission costs and extraneous costs.

**MasterCard scheme must allocate costs on the same basis as its competitors**

**Summary of arguments made**

699. MMF argues that the OFT has ignored the fact that the MasterCard scheme cannot compete with other payment card schemes unless issuers and acquirers are free to recover the costs arising from MasterCard credit card transactions as they choose. Therefore, freedom for the MasterCard scheme to balance costs between issuers and acquirers on same basis as competing payment card schemes is objectively necessary for the operation of the MasterCard scheme.

**The OFT’s response**

700. The OFT does not accept this argument, for the reasons given in paragraph 639 above.

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580 Mr Richard Fowler QC: pages 103-104, Transcript of joint oral representations on the SO.  
581 See paragraphs 595-600 above.  
582 Paragraphs 4.121-4.123, Joint written representations on the SO.
The extraneous costs restriction falls within the Horizontal Guidelines

Summary of arguments made

701. MMF argues that, applying the Horizontal Guidelines, the extraneous costs restriction is not caught by Article 81(1) or the Chapter I prohibition because it falls within the Horizontal Guidelines.583

The OFT’s response

702. All of the arguments made at paragraphs 451-472, in relation to the collective price restriction, apply equally in relation to the extraneous costs restriction. In addition, the following points are made.

703. As regards paragraph 19 of the Horizontal Guidelines and paragraph 24 of the Article 81(3) Notice, the MMF MIF agreement clearly has a negative market effect as to prices, since, by enabling recovery of extraneous costs, it inflates MSCs and, in turn, leads to higher retail prices of merchants accepting MasterCard credit and charge cards than would be likely to apply if the MMF MIF were not calculated with reference to extraneous costs.

704. With regard to the second sub-paragraph of paragraph 24 and paragraph 87 of the Horizontal Guidelines and paragraph 18(2) of the Article 81(3) Notice, even if a MIF could be considered necessary and integral to the proper functioning of the MasterCard scheme (which the OFT does not accept), the full extent of the Parties’ cooperation (i.e. the full extent of cost recovery through the agreed MIF and, in particular, the recovery of extraneous costs) cannot be said to be necessary or integral.

The MasterCard scheme is a joint product with joint costs

Summary of arguments made

705. MMF argues that the MasterCard scheme must be regarded as a single product which is jointly produced by issuers and acquirers.584 The OFT cannot segment the features of the MasterCard scheme and assert that specific features of this scheme benefit merchants only or cardholders only. All features of the scheme benefit cardholders and merchants. It is not possible to separate the services provided by issuers and acquirers: they are necessarily joint and indivisible.

706. According to MMF, there is complete interdependence and strict complementarity between the activities of issuers and acquirers that benefit cardholders and the activities of issuers and acquirers that benefit merchants. As a joint product, the costs of the MasterCard scheme cannot be segmented into payment transmission costs and other costs. The MasterCard scheme satisfies demand from cardholders and

583 Paragraph 4.124, Joint written representations on the SO.
584 Paragraphs 4.149-4.154, Joint written representations on the SO.
merchants, therefore the costs of the scheme are joint costs. It is therefore legitimate to recover these costs from cardholders and merchants. There is no single, correct way to allocate these costs, and any allocation method would be arbitrary. It cannot be expected that cardholder charges should equal issuer costs or that merchant charges should equal acquirer costs. The MMF MIF enables recovery of all costs of the MasterCard scheme from cardholders and merchants based on the value that each group places on participation in the scheme.

707. MMF and RBSG argue that the OFT has no basis for distinguishing between payment transmission costs and extraneous costs. Cardholders and merchants should contribute to a cost of the MasterCard scheme because they benefit from its features, and the OFT has no basis for finding otherwise.

The OFT’s response

708. The OFT’s response to arguments that that the services provided by issuers and acquirers to merchants and cardholders constitute a single product, and that there is interdependence and strict complementarity between the activities of issuers and acquirers, is set out above in paragraphs 595-599 above. The basis for the OFT’s distinction between extraneous costs and payment transmission costs is set out at paragraphs 526-527 above. Despite the Parties’ arguments, the OFT believes that this distinction is clear, natural and analytically correct. Therefore the OFT does not accept that all costs incurred by issuers in supplying extraneous services to cardholders can be allocated to merchants without giving rise to a restriction of competition.

Merchants should contribute to interest-free and cardholder default guarantee costs

Summary of arguments made

709. MMF argues specifically that costs of providing an interest-free period to cardholders and the costs of a payment guarantee against cardholder default cannot be treated as extraneous costs and that merchants should contribute to these costs.

COSTS OF THE INTEREST-FREE PERIOD

710. MMF argues that the interest-free period is an important factor in increasing credit and charge card usage. Without the interest-free period, the number of cardholders and usage of credit and charge cards would be lower and merchants should absorb the cost of providing this service in return for the increased turnover and profits that they derive from the patronage of credit-worthy customers. Moreover, it claims that the

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585 Paragraphs 4.131-4.148, Joint written representations on the SO.
586 Paragraphs 3.1-3.9, RBSG written representations on the SO (18 February 2005).
587 Paragraphs 4.164-4.189, Joint written representations on the SO.
interest-free period increases aggregate consumption and aggregate demand: credit card expenditure is not merely replacing other expenditure.\textsuperscript{588}

711. MMF states that the interest-free period, and the cost associated with it:

\textquote{...reflect the fact that acquirers undertake to provide merchants with near immediate payment (and issuers likewise to acquirers) while collection from the cardholder occurs at a later date. To isolate the interest-free period as a straightforward bilateral agreement with [a] cardholder, to which merchants are indifferent, fails to take account of the equally “straightforward” bilateral agreement with the merchant as to timing and payment. There is no justification for segmenting the MasterCard product and asserting that parts of it are provided either only to merchants on a bilateral basis or only to cardholders on a bilateral basis. It is necessary to take account of the “entire transaction".}\textsuperscript{589}

712. According to MMF, the OFT is incorrect to find that the costs providing an interest-free period arise from bilateral arrangements between cardholders and issuers because:

(i) The costs of providing an interest-free period are costs that issuers incur in providing the MasterCard product to both cardholders and merchants.

(ii) The provision of an interest-free period allows merchants to make additional sales by differentiating themselves from competing merchants.

(iii) There is no reason for departing from the Commission’s reasoning in the Visa MIF decision that costs of providing an interest-free period can be recovered through the MMF MIF.

(iv) Finding that the costs of providing an interest-free period cannot be charged to merchants creates inconsistency within the OFT’s case: it finds that the provision of an interest-free period is not integral to the MasterCard scheme but accepts that merchants benefit from this through increased sales.

(v) The cost of the interest-free period is incurred because transfer of cardholder funds does not occur immediately upon sale. There is no single method of allocating these costs. The fact that this cost is initially incurred by the issuer cannot preclude its reallocation between issuers and acquirers.

\textsuperscript{588} See, for example, paragraph 7.3.24, MMF written representations on the R14; paragraphs 5.3.45, 5.3.61 and following, Joint written representations on the SR14.  
\textsuperscript{589} Paragraph 4.173, Joint written representations on the SO.
COSTS OF GUARANTEE AGAINST CARDHOLDER DEFAULT

713. MMF argues that the OFT is incorrect to find that the costs providing an payment guarantee arise from bilateral arrangements between cardholders and issuers because:

(i) A payment guarantee is part of the service provided to merchants and benefits merchants. It allows merchants to complete a sale and receive payment even where a cardholder cannot afford to purchase and to make additional sales without the risk of default where a payment guarantee is offered.

(ii) The payment guarantee is more valuable to merchants than it is to cardholders.

(iii) There is no basis for departing from ECJ and UK court precedents, and the Commission’s Visa MIF decision, that the service provided to merchants in a four-party credit card scheme includes that of guaranteed payment.

(iv) The distinction between cardholder default arising from the voluntary extension of credit and the involuntary extension of credit is unclear and unworkable.

714. Similarly, RBSG argues that payment guarantee against cardholder default is so fundamental that without it the MasterCard scheme could not operate as a viable payment transmission mechanism.590

The OFT’s response

COSTS OF THE INTEREST-FREE PERIOD

715. The OFT does not accept that an interest-free period is integral to the operation of the MasterCard scheme as a payment transmission mechanism. In distinguishing between the categories of costs recovered through the MMF MIF, the OFT’s focus is not whether a feature of the MasterCard scheme arises from “a straightforward bilateral agreement” but whether the feature is integral to the operation of the scheme as a payment transmission mechanism.591 The OFT’s reasons for its finding that the interest-free period is not integral are given in paragraphs 570-571 above. Recognising that accepting MasterCard cards may benefit individual merchants (by allowing them to win business from rival merchants who do not accept MasterCard cards) does not also require the OFT to find that the provision of an interest-free period is integral to the MasterCard scheme.

716. The OFT’s approach to considering the Commission’s Visa MIF decision is set out in paragraph 643-646 above. Its assessment of whether the costs

590 Paragraph 3.25, RBSG written representations on the SO (18 February 2005).
591 See paragraphs 526-527 above.
of an interest-free period should be recovered through the MMF MIF is consistent with this approach.

COSTS OF GUARANTEE AGAINST CARDHOLDER DEFAULT

717. The OFT accepts that elements of the payment guarantee against default relating to 'transactional default' are inherent to any four-party payment card scheme. The costs in relation to 'transactional default' are therefore payment transmission costs\(^{592}\) and it may be efficient for merchants to contribute to these costs. However, for the reasons given in paragraphs 576-577 above, the provision of a payment guarantee against default going beyond transactional default is not necessary to the operation of the MasterCard scheme as a payment transmission mechanism and therefore the costs of this feature are not payment transmission costs.

718. As to the suggestion that the payment guarantee against default is more valuable to merchants than to cardholders, survey evidence put forward by MMF shows that, to the contrary, merchants do not significantly value the payment guarantee against default. Furthermore, evidence provided by the Parties does not support the contention that merchants value the payment guarantee. As indicated in paragraph 623 and Annex 8 of this Decision, evidence suggests that in looking at 78 different merchant groups it cannot be reliably concluded that any of these groups value the payment guarantee aspect of a payment card.

719. In any event, the provision of a payment guarantee against default going beyond transactional default is inextricably linked with the offering of credit to cardholders. For the reasons explained at paragraph 595, credit services are not integral to the payment transmission mechanism.

720. Again, the OFT's assessment of whether the costs of the guarantee against cardholder default should be recovered through the MMF MIF is consistent with the approach taken in the Commission's Visa MIF decision as set out in paragraphs 647-649 above.

721. The OFT notes MMF's argument that a distinction between voluntary and involuntary extension of credit is unclear and unworkable. The OFT does not accept that such a distinction is unclear or unworkable. However, even if it were, in these circumstances MMF could not be permitted to recover extraneous costs through the MMF MIF in breach of Article 81 and the Chapter I prohibition simply because it could not distinguish extraneous costs from other costs of providing the payment guarantee against cardholder default. Rather, in order to comply with the law, MMF would have to exclude all of the costs of the payment guarantee against cardholder default from its calculation of the MMF MIF, until such time as it has devised an appropriate method for distinguishing between voluntary and involuntary extension of credit.

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\(^{592}\) See paragraphs 573-575 above.
Allocation of costs cannot give rise to a restriction

Summary of arguments made

722. MMF argues that the allocation of costs within the scheme does not affect the competitive position of issuers or acquirers and the recovery of these costs through the MMF MIF cannot restrict competition.

723. According to MMF, the OFT’s finding that the recovery of extraneous costs through the MMF MIF is a restriction of competition arises from its incorrect treatment of the MMF MIF as a price rather than a default balancing mechanism. In addition, the OFT’s finding that the recovery of these costs through the MMF MIF affects competition between the MasterCard scheme and other payment methods is inconsistent with its market definition, in which it concludes that other payment methods do not compete with the scheme. Any competition between the scheme and other payment methods would be residual at best. The OFT cannot argue simultaneously that its market definition is correct and that benefits to cardholders distort competition between payment systems.

724. The Parties must be free to allocate the costs of the MasterCard scheme based on what is necessary to enable it to compete effectively. A reduced MIF would result in a MasterCard scheme with reduced benefits and ubiquity, and which is less desirable to cardholders (and, consequently, there would be fewer transactions within the scheme). The direct result of a reduced MIF would be that the MasterCard scheme loses business to its competitors.

725. Whatever amount the MMF MIF is set at, it will involve the Parties incurring a common cost or receiving a common revenue.

The OFT’s response

726. The OFT does not accept that allocation of costs within the MasterCard scheme is incapable of causing a restriction of competition. As set out in paragraphs 685-693 above, the recovery of extraneous costs through the MMF MIF leads to restrictions of competition in both issuing and acquiring.

727. For the reasons given in paragraphs 172-178 above, the OFT does not accept that the MMF MIF is not a price.

728. The OFT’s finding that recovering extraneous costs through the MMF MIF affects competition between the MasterCard scheme and other payment methods is consistent with its market definition. As a matter of fact, it is possible for a restriction of competition to cause effects beyond the boundaries of the relevant market(s), however defined, within which the restriction is analysed. Market definition only provides a starting point for

593 Paragraphs 4.190-4.200, Joint written representations on the SO.
594 Paragraph 2.9, Lloyds TSB written representations on the SO (21 February 2005).
the analysis of a restriction of competition, and there is no reason why market definition and the markets within which the effects of that restriction occur should be symmetric.595

729. As stated in paragraphs 639 above, the OFT does not accept that the costs of additional features can be recovered through the MMF MIF simply because other payment methods may do this.

APPRECIABLE RESTRICTION OF COMPETITION

730. As a result of the recovery of extraneous costs through the MMF MIF, the OFT considers that the MMF MIF agreement has an appreciable effect on competition for the purposes of Article 81(1) and the Chapter I prohibition, for the reasons given in paragraphs 503-511 above and because it leads to extraneous costs being passed on directly to merchants and indirectly to consumers in general.

CONCLUSION ON THE APPLICATION OF ARTICLE 81(1) AND THE CHAPTER I PROHIBITION TO THE EXTRANEOUS COSTS RESTRICTION

731. Having considered carefully the representations and submissions received in the administrative procedure preceding this decision, the OFT remains of the view that the extraneous costs restriction contained in the MMF MIF agreement restricts competition in the common market (for the purposes of Article 81(1)) and within the UK (for the purposes of the Chapter I prohibition. Accordingly, it must be considered whether this restriction meets the conditions for exemption contained in Article 81(3) and section of the CA98.

THE APPLICATION OF ARTICLE 81(3) AND SECTION 9 OF THE CA98 TO THE EXTRANEOUS COSTS RESTRICTION

732. The recovery of extraneous costs through the MMF MIF allows these costs to be passed on and recovered from merchants directly (through an MSC which is higher than it would otherwise be) and from consumers indirectly where merchants increase retail prices to recover the costs of MSCs.596

733. As noted above in paragraph 538, network externalities could mean that a scheme could be more efficient where a MIF is set by reference to (and used to recover) extraneous costs. Given the important discrepancy between private benefits of individual merchants on one hand and total benefits of merchants in aggregate on the other, efficiencies arising in these circumstances would need to be precisely demonstrated. The OFT does not believe that the MMF MIF, which is used to recover extraneous costs, leads to a significantly more efficient scheme than one where a MIF was set at or below the level of payment transmission costs incurred by issuers. The OFT does not consider, therefore, that the extraneous costs

595 See paragraphs 325-327 above.
596 The OFT relies on its analysis in paragraphs 579-587 above.
restriction gives rise to any efficiency benefits, which outweigh the
detriment to competition arising from the recovery of extraneous costs
through the MMF MIF, for the purposes of the first exemption condition.
The OFT’s view is that the MMF MIF is being used by the Parties, not to
balance externalities in order to maximise efficiency, but as a vehicle to
extract revenues from merchants for services unrelated to the operation of
the MasterCard scheme as a payment transmission mechanism and which
primarily benefit issuers and some cardholders. These services include the
extraneous services, costs of which are taken into account in setting the
MMF MIF, but also services connected with, for example, provision of
loyalty and affinity cards.

734. One possible way of demonstrating network externalities that could
provide a basis for justifying the MMF MIF set above the level of payment
transmission costs could be to show that the extraneous services, the
costs of which are taken into account in setting the MMF MIF, sufficiently
benefit merchants in aggregate so as to outweigh the detriment identified.
The OFT therefore considers it appropriate to consider MMF’s arguments
with regard to benefits to merchants from extraneous services in this part
of its Decision.

**Merchants benefit from the recovery of extraneous costs through the
MMF MIF**

**Summary of arguments made**

**EXTENT OF BENEFITS**

735. MMF argues that the MasterCard scheme provides a number of benefits
which are highly valued by merchants. Merchants who accept
MasterCard cards have a competitive advantage over those who do not
(e.g. they can make sales on credit which are not dependent on customers
having sufficient funds).

736. Evidence shows that the provisions of an interest-free period increases
aggregate consumption and aggregate demand experienced by all
merchants: credit card expenditure is not merely replacing other
expenditure. The MasterCard scheme is highly valued by merchants
who recognise that the provision of an interest-free period to cardholders
and loyalty schemes are the main contributors to incremental expenditure
by cardholders. Merchants also value the near immediate payment
provided by the scheme and are prepared to pay for this feature. The
MasterCard scheme: “... is not simply the process of transferring payment
from cardholders to merchants but also that of allowing the merchant to
make additional sales that he would not otherwise have made had he not
offered credit and of doing so without having to incur the (likely higher)

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597 Paragraphs 4.125-4.130 and 4.155-4.163, Joint written representations on the SO.
598 See, for example, paragraph 7.3.24, MMF written representations on the R14 (18
January 2002) and paragraphs 5.3.45, 5.3.61 and following, Joint written
representations on the SR14.
cost of providing his own credit scheme." It has additional features not present in other payment methods and merchants' willingness to pay for these features is evidence of the extent to which they value them. For cardholders, the option of deferred payment distinguishes the MasterCard scheme from other payment transmission mechanisms. For merchants, it is more than this because it offers customers deferred payment which is valuable because it generates incremental sales and means merchants need not provide credit arrangements themselves.

**The OFT's response**

**EXTENT OF BENEFITS**

737. As noted in paragraph 538 above, the OFT accepts that, in theory, network externalities could conceivably mean that a four-party payment card scheme would be more efficient with a MIF which is set by reference to (and used to recover) extraneous costs. If those network externalities were sufficiently large then, in theory, it might be efficient for the MMF MIF to exceed the level of payment transmission costs. However, the OFT notes that network externalities could equally work in the opposite direction (i.e. cardholders benefit from additional merchant acceptance of MMF cards). This suggests that proper evaluation of network externalities cannot focus purely on the effects on one side of the market. In addition, the OFT has found no evidence to suggest that a level of externalities exists to justify a MIF payable by acquirers set at a level above payment transmission costs of issuers.

738. In addition for the reasons given in paragraphs 552-557 above, the OFT does not accept MMF's argument that merchants' willingness to pay an MSC is evidence of the value they place on the MasterCard scheme (or specific features such as an interest-free period). MMF's argument is based on a Baxter analysis, which uses merchants' willingness to pay for accepting MasterCard cards as a measure of the benefit which they enjoy from card acceptance. In essence, MMF asserts that merchants can legitimately be charged for the costs of any feature of the MasterCard scheme irrespective of how peripheral it may be to the operation of the scheme as a payment transmission mechanism. This assertion is made particularly in Joint oral representations on the SO, in which it was stated that "...everything that the issuer does that contributes to the making of a transaction on the card is a benefit both to the cardholder and to the merchant. There is nothing which is done either by the issuer or the acquirer that does not benefit both cardholder and merchant."

739. The OFT considers that there are a number of flaws in this analysis, which it identifies in paragraphs 635-636 above and in Annex 11 of this Decision. In summary, this analysis rests on the assumption that if merchants do not benefit from accepting MasterCard credit and charge cards then they will cease accepting them. As stated, the OFT considers

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599 Paragraph 4.129, Joint written representations on the SO.
600 Letter from Jones Day to the OFT (25 April 2005).
601 Mr Carl Munson: page 86, Transcript of joint oral representations on the SO.
that willingness of *individual* merchants to pay for the ability to accept credit cards overstates the *aggregate* merchant benefits of such acceptance. Consequently, it does not accept that claimed benefits to merchants justify the recovery of extraneous costs through the MMF MIF. For the same reason, the OFT does not accept that the correct test for determining whether a cardholder or merchant should contribute to (or indeed, pay all of) a cost of the MasterCard scheme is whether it relates to a feature of the scheme which provides them with individual benefits.

740. The specific arguments that the MasterCard scheme causes an increase in incremental spending by cardholders and a permanent increase in retail spending (through the provision of an interest-free period) are addressed by the OFT in paragraphs 581-582 above.

**CONCLUSION ON THE APPLICATION OF ARTICLE 81(3) AND SECTION 9 OF THE CA98 TO THE EXTRANEOUS COSTS RESTRICTION**

741. The Parties have not demonstrated that there are benefits from setting the MMF MIF with reference to extraneous costs which represent appreciable objective advantages of such a character as to outweigh the disadvantages to competition of doing so.\(^{602}\) As noted at paragraph above, network externalities mean that a scheme *could* be more efficient with a MIF which was set above the level of payment transmission costs. However, the Parties have not demonstrated that the MMF MIF does generate such efficiency benefits.

742. To the extent that it includes the extraneous costs restriction, the MMF MIF agreement cannot meet the first exemption condition. Therefore, it is unnecessary to consider the application of the remaining exemption conditions to this restriction.

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\(^{602}\) See paragraphs 539 and 632 above.
III  DECISION

743. For the reasons which are contained in this Decision and which are based on the facts set out above, the OFT finds that the MMF MIF agreement, which applied from 1 March 2000 to 18 November 2004, restricted competition within the meaning of Article 81(1) and the Chapter I prohibition and did not meet the exemption conditions set out in Article 81(3) and section 9 of the CA98.

744. The OFT notes that the MCI Global Board of Directors at its meeting on 18 November 2004 resolved to rescind MMF’s delegated authority under the UK Domestic Rules to set the level of fallback interchange fees and fallback service fees for MasterCard branded consumer and commercial cards in the UK with immediate effect.

745. From 18 November 2004, [REDACTED]. These arrangements that have been in place since that date are not specifically considered in this Decision. However, the principles which inform this Decision are likely to be applicable to the new arrangements.

A  PENALTIES

746. The MMF MIF agreement forms part of the agreements that were notified to the OFT, although the notification has lapsed on 1 May 2004. This being so, the OFT does not consider it appropriate to impose a penalty in this case.

B  DIRECTIONS

747. Since the agreement that leads to the infringement described in this Decision has now ceased, the issue of directions does not arise.

John Vickers
Chairman of the Office of Fair Trading
6 September 2005