MasterCard interchange fees damages cases

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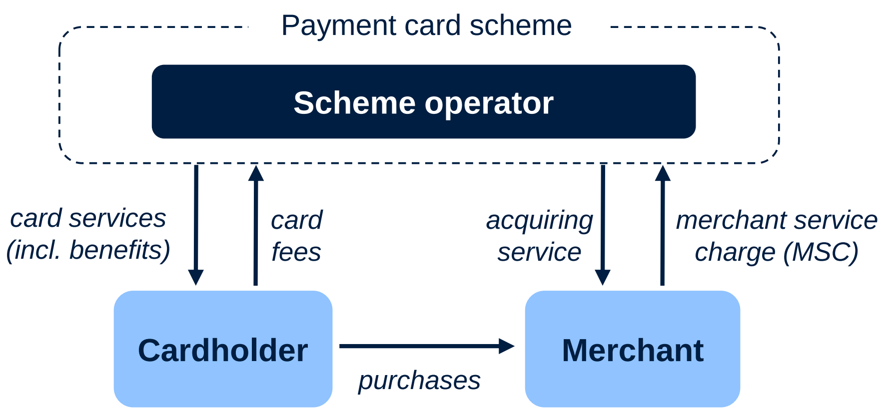
oxera
compelling economics

Overview

Part I
Introduction

Payment card schemes as two-sided platforms

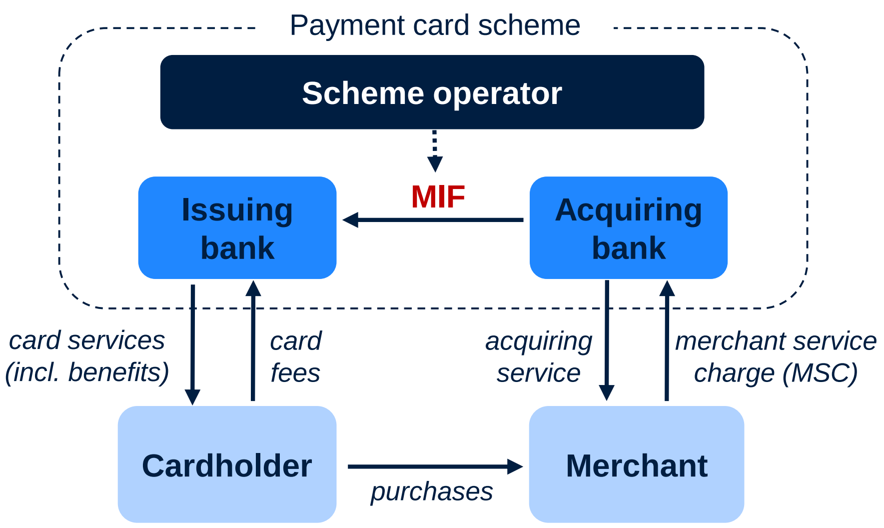
Structure of a three-party card scheme



- card schemes are **two-sided platforms** that bring together two types of users—cardholders and merchants
  - there is a positive externality involved as the more users there are on one side, the more attractive the platform is to the other side
- this gives rise to a **skewed pricing structure** if one side has a lower willingness to pay—in the case of cards this tends to be the cardholders

Four-party card schemes
Interchange fee required to balance costs and revenues

Structure of a four-party card scheme



- a four-party card scheme such as MasterCard balances revenues and costs among the participating banks through an **interchange fee**
- the multilateral interchange fee (MIF) set by the card scheme is the default interchange fee that applies in the absence of an agreement between an issuing and an acquiring bank (a bilateral agreement)

Timeline

Selected competition cases involving interchange fees

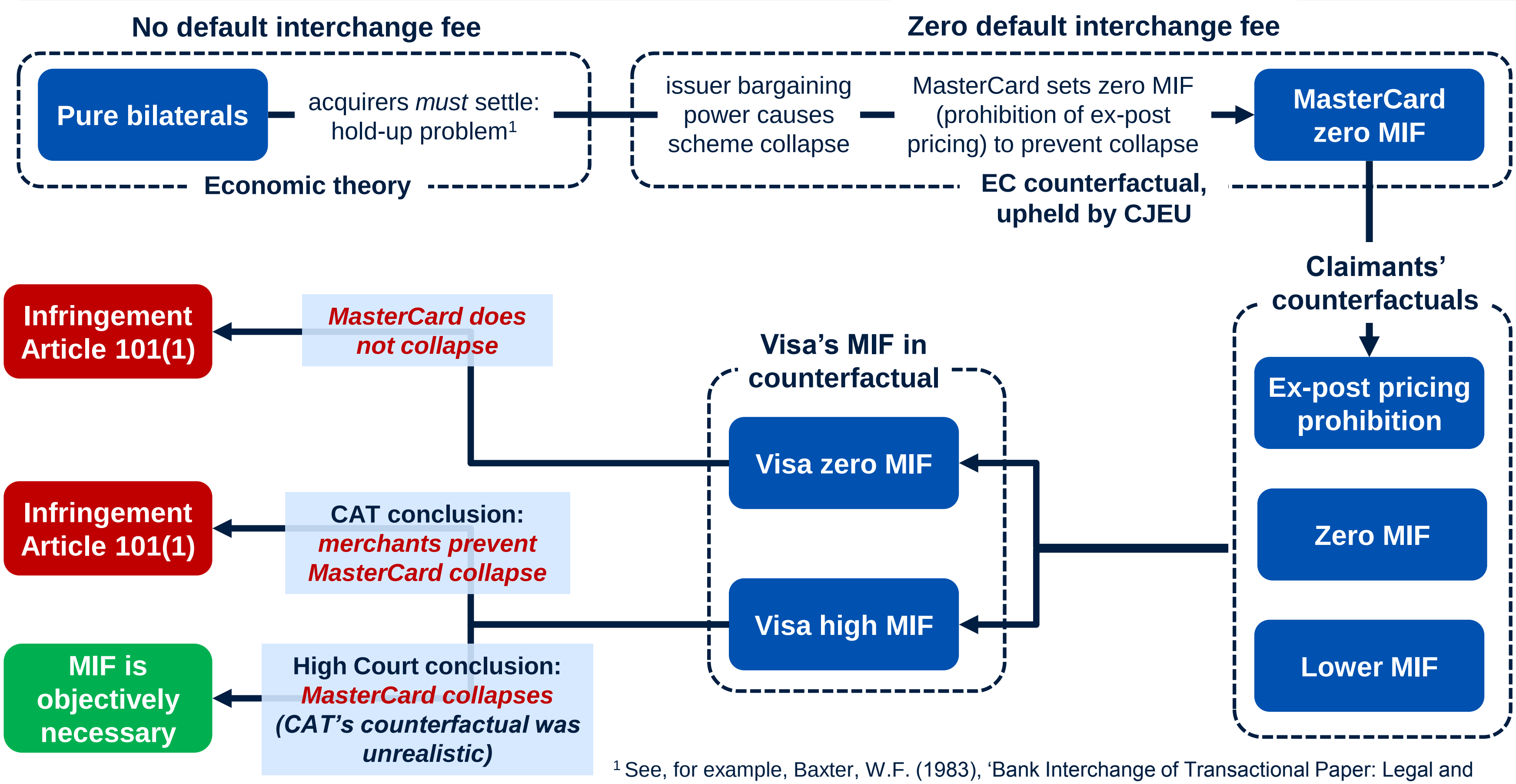
NaBanco sues Visa in the US; the court validates Visa's cost-based methodology for determining interchange fees[1]	1984			
MasterCard notifies the EC of its network rules, including the MIF (investigation formally opened in 1999)	1992			
EC finds that MasterCard's MIF for cross-border transactions (intra EEA MIF) restricts competition[2]	2007			
The General Court upholds the EC's Decision[3]	2012		2012	Retailers brings damages claims for hundreds of millions of pounds against MasterCard and Visa in the UK
The EU Court of Justice (CJEU) also upholds the EC's Decision[4]	2014			
The European Parliament and the Council of the European Union adopt the Interchange Fee Regulation[5]	2015			
			2016	The **CAT** in the UK finds that MasterCard's domestic interchange fees restrict competition and awarded damages of £68m to Sainsbury's. It rules that the pass-on defence is not available to MasterCard *(Sainsbury's v MasterCard)*[6]
			2017	The UK **High Court** finds that MasterCard's domestic interchange fees did not restrict competition and would be exempt (*Arcadia & Ors v MasterCard)*[7]

[1] National Bancard Corp (NaBanco) v Visa USA, 596 F. Supp. 1231 (S.D. Fla. 1984). [2] Case nos COMP/34.579, COMP/36.518 and COMP/38.580, *MasterCard, EuroCommerce and Commercial Cards*, Commission Decision of 19 December 2007. [3] Case T-111/08, *MasterCard Inc and Others v Commission*, the General Court Decision of 24 May 2012. [4] Case C-382/12 P, *MasterCard Inc and Others v Commission*, the Court of Justice of the European Union Decision of 11 September 2014. [5] Regulation (EU) 2015/751 of the European Parliament and of the Council of 29 April 2015 on interchange fees for card-based payment transactions. [6] Case No. 1241/5/7/15 (T), *Sainsbury's Supermarkets Ltd. v MasterCard & Ors*, CAT Decision of 14 July 2016. [7] Case No. [2017] EWHC 93 (Comm), *Arcadia & Ors v MasterCard & Ors,* UK High Court (Commercial Court) Decision of 30 January 2017.

Part II
Counterfactual analysis

Counterfactual analysis

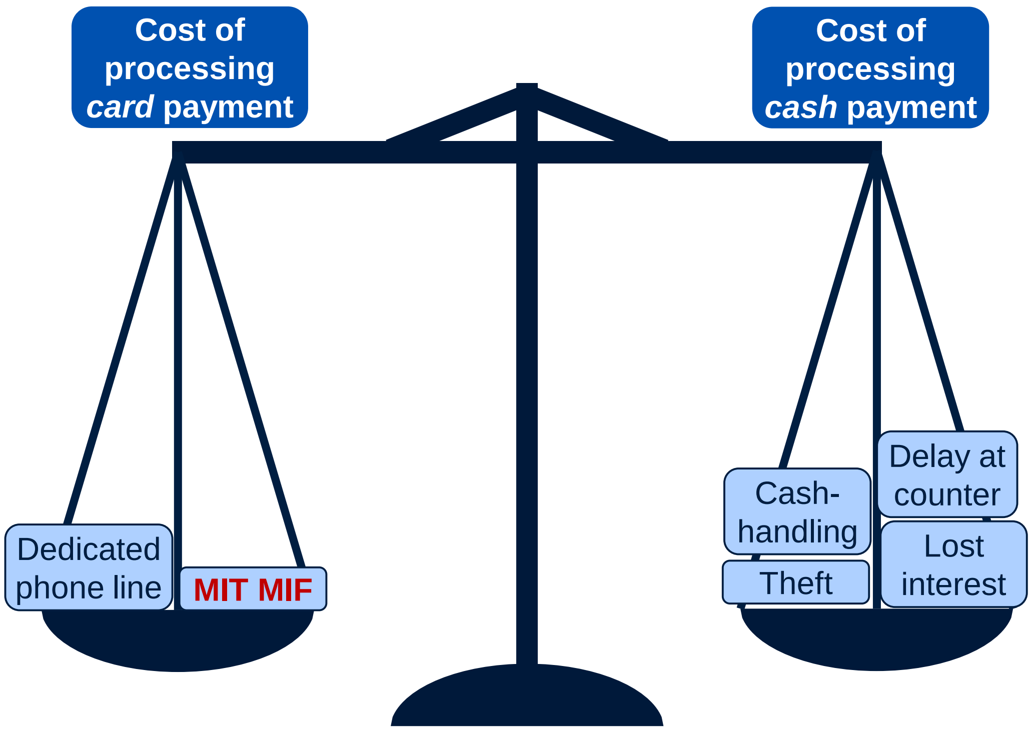
Would interchange fees be lower and/or would MasterCard be viable?



[1] See, for example, Baxter, W.F. (1983), 'Bank Interchange of Transactional Paper: Legal and Economic Perspectives', *Journal of Law and Economics*, 26, 541–88; Small, J. and Wright, J. (2002), 'The Bilateral Negotiation of Interchange Fees in Payment Schemes', January (unpublished paper)

Part III
The Merchant Indifference Test

The Merchant Indifference Test (1)



- developed by Rochet & Tirole (2007)[1]
- EC's preferred approach to determine the exemptible level of the MIF
- sets MIF at a level that internalises the merchant-cardholder externality
- this is the case if the merchant is indifferent between a payment by card and its alternative (cash)

In 2015, the EC estimated the 'MIT MIF' to be around 0.13% for credit cards

- based on a survey of merchants' costs of processing cash and card payments
- this informed the 2015 European Interchange Fee Regulation

[1] Rochet, J.C., and Tirole, J. (2007), 'Must-Take Cards and the Tourist Test', DNB Working Paper No. 128, January.

The Merchant Indifference Test (2)
Theoretical shortcomings and adjustments

The MIT does not take account of the benefits of credit

- some transactions will take place only if credit is available
- use weighted combination of the cost of cash (for ordinary purchases) and the costs that the merchants incurs for payments, where the consumer does not have the required funds (e.g. Amex)
- based on Rochet & Wright (2010)[1], who modelled interchange fees specifically for credit cards

The MIT focuses on face-to-face transactions

- cash is not a relevant comparator for online transactions
- the comparator set needs to be adjusted to include online payment methods (e.g. PayPal)

The MIT focuses on an increment of one transaction

- the original MIT theory does not consider costs that vary in the longer term
- costs that vary in the longer term need to be included to ensure that the MIF creates the right long-run incentives; see Rysman and Wright (2015)[2]

[1] Rochet, J.C. and Wright, J. (2010), 'Credit card interchange fees', Journal of Banking & Finance, 34:8, pp. 1788–797. [2] Rysman, M. and Wright, J. (2014), ' The Economics of Payment Cards', Review of Network Economics, vol. 13, issue 3, 303-353.

Adjustments to the MIT

Oxera's adjusted MIT MIF and the High Court's estimate

Oxera adjusted the European Commission's MIT MIF analysis:

- both conceptual and practical adjustments
- the High Court accepted Oxera's analysis and implemented additional adjustments

Implication MasterCard's UK MIF is exemptible under Article 101(3)

Part IV
Pass-on

Oxera's pass-on analysis

Strong economic presumption that the rate of pass-on by Sainsbury's is very high, potentially 100%

- Sainsbury's operates in a highly competitive market
- UK MIF/MSC can be treated as market-wide cost shocks since all of the large retailers, including Sainsbury's, accepted payment cards during the relevant time period
- variable costs like MIF/MSC are more likely to be passed on than fixed costs

Empirical analyses supported theoretical insights

- a direct empirical assessment of the relationship between the MSC and Sainsbury's prices was not feasible
  - MSCs did not vary materially over the claim period
  - the MSC accounts for a very small fraction of Sainsbury's total costs
- Oxera's econometric analysis assessed Sainsbury's response to costs that are of a similar nature to MSCs (e.g. VAT changes)
  - the analysis suggested that Sainsbury's fully passes on its variable costs

CAT’s assessment of pass-on

What did the CAT say?

Question 1: assume the MIF amounted to an overcharge—did Sainsbury’s pass it on to its customers?

- **the CAT (broadly) said yes:**
  - ‘pass on is a fact of economic life’ (para. 433)
  - Sainsbury’s did not make less profit over the claim period (para. 463)
  - Sainsbury’s would have passed on a substantial amount (50%) of the overcharge to its customers because it was a common cost shock (para. 525)
  - CAT states they it did not need extensive submissions to tell it that – it was ‘blindingly obvious’ (para. 468)

Question 2: does this sense of passing on amount to a legal defence that reduces the damages?

- **the CAT said no:**
  - ‘the increase in price must be causally connected with the overcharge, and demonstrably so’ (para. 484)
  - ‘no identifiable increase in retail price has been established, still less one that is causally connected with the UK MIF’ (para. 485)
  - impossible to tell which part of the price of any given product was attributable to the MIF (para. 459)

Implication

- higher standard of proof than previously perceived?

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