

1 think individually when an acquirer does this
 2 negotiation in that setting will be so enlightened
 3 because the acquirer will think, I can either get zero,
 4 which means very low interchange, which means I can give
 5 a good deal to my merchant, or it can think, no, if
 6 I pay a bit more then the scheme will survive and
 7 therefore me and all my rivals are better off.
 8 I haven't thought it through in detail, but I
 9 think --
 10 MR JUSTICE BARLING: There are only half a dozen of them,
 11 aren't there?
 12 A. Sorry?
 13 MR JUSTICE BARLING: There are only half a dozen rivals.
 14 It's not as though we're dealing with a huge mass of
 15 people.
 16 A. They are fierce rivals, so what is collectively good for
 17 them is not necessarily what they would be driven by
 18 when they negotiate individually.
 19 I think somehow I feel that the key is there. It is
 20 a bit actually the flip side of the bilaterals
 21 situation, the situation where the issuers do have some
 22 bilateral market power without the multilateral
 23 interchange fee. Again, the logic of the models is,
 24 individually, those issuers would actually price very
 25 high, but collectively they might think but if we all

69

1 price too high then, like patent holders, for example,
 2 if we all price too high then we collapse our own
 3 scheme.
 4 So there is that -- it is a bit of a mirror image of
 5 that.
 6 MR SMITH: Let's assume one of the big acquirers -- as the
 7 Chairman has said, the market seems to be quite
 8 concentrated, there are about six large acquiring banks
 9 if MasterCard's table is to be followed -- and we have
 10 a negotiation between an issuing bank and an acquirer,
 11 and the issuing bank is saying you have got to pay me
 12 something, I would like a positive interchange fee with
 13 money going my way. Of course you are right, the
 14 acquirer could say no, it is in my interests to offer my
 15 merchant's the lowest price and so I want to cut the
 16 interchange to zero.
 17 Wouldn't an acquiring bank have two thoughts at this
 18 stage? One would be the Chairman's point, that issuing
 19 banks can simply drift away to Visa from MasterCard and
 20 MasterCard effectively collapses as a scheme and the
 21 period of zero MIFs is a short and perhaps happy one,
 22 but very short. So in a sense one is destroying
 23 competition in the market for a very short-term benefit.
 24 There's that consequence, which acquirers would have in
 25 mind.

70

1 Secondly, wouldn't there also be an impetus on
 2 MasterCard to cut back some of the benefits that
 3 merchants receive through the operation of the card
 4 system? I'm thinking in particular of the guarantee of
 5 payment in the case of fraud or where the account holder
 6 doesn't have enough money in his or her account, these
 7 benefits. I'm leaving on one side things like the
 8 30-day credit, but that too could be regarded as
 9 benefit. You would get a scaling back of the scheme.
 10 Again, isn't that something that an acquiring
 11 sophisticated bank would bear in mind?
 12 A. Yes. So we are talking here actually about a scheme
 13 that is potentially quite -- so quite different from the
 14 existing one. So we have made a few changes. So there
 15 is this zero default. The default interchange fee is
 16 zero so you can't charge. I'm still struggling a little
 17 bit with that one, what the benefits of that would be.
 18 But let's say if that were the rule, I do still think
 19 that the individual acquirer would -- in individual
 20 negotiation -- because the zero is there for grabs.
 21 That is the default. No effort required. I do not
 22 think any acquirer individually would be so generous as
 23 to think to the greater good of everyone for the
 24 survival of the scheme.
 25 Partly -- there is a bigger question of okay, what's

71

1 the acquirer's incentives here in the first place, but
 2 the acquirer is usually acquiring a multiple scheme.
 3 They offer payments for multiple schemes. So this
 4 choice -- the competition between payment schemes, the
 5 competition between, say, MasterCard, Visa and Amex is
 6 much starker at the issuing level where issuers have to
 7 make a choice: do I issue this or do I issue the other?
 8 So in terms of incentives, the incentives are --
 9 MR JUSTICE BARLING: Some issue both, don't they, or
 10 several?
 11 A. They do, but then they can switch. This bit of
 12 customers gets Amex and these get -- they do have both.
 13 But on the issuing side, the question "Which scheme do
 14 I prefer" is much more a live question than for
 15 acquirers. I think in general terms that is sort of the
 16 first bit of the question.
 17 The second bit goes into the -- what other changes
 18 can the schemes make? Or shall we stick to the first
 19 one?
 20 MR SMITH: I was simply articulating that as a possible
 21 consequence of an acquirer insisting on a zero MIF.
 22 I wasn't suggesting as a counterfactual a dramatically
 23 scaled back scheme.
 24 The only assumption I was asking you to make was
 25 only a bilateral interchange fee could be agreed and

72

1 there would be no default, or a default of zero, if you
2 like. That's all I was putting to you.

3 But can I ask you one last question. Again, it is
4 accepted by everyone that actually the acquirers are, in
5 terms of their monetary gain or loss, indifferent as to
6 the level of the interchange fee because they pass it on
7 to the merchant. Doesn't that suggest that they might
8 have in mind a more nuanced longer term view of what the
9 interchange fee should be? Because after all it doesn't
10 affect their bottom line; all they are seeking to do in
11 negotiating the best interchange fee is something that
12 is in the best interests of themselves, vis-a-vis the
13 merchants who are their customers.

14 A. Yes. I think generally the position of acquirers -- and
15 this goes back to Professor Beath's question a few weeks
16 ago: where are acquirers in this? Why are they so
17 apparently passive? I think collectively acquirers,
18 yes, they pass it on, the MIF to the MSC. But I have to
19 bring in analogy.

20 Let me bring in the analogy of petrol stations as
21 acquirers, if you like. So petrol stations, there is
22 certain competition between petrol stations and that's
23 the same whether, say, the government duties on petrol
24 are 30p or 100p, the competition stays the same. And
25 you would be rightly saying, well, it doesn't really

73

1 matter to the competition between these petrol stations
2 or acquirers whether the MIF is 30 or 100.

3 But on the whole though, if anything, petrol
4 stations would prefer it if the government duties
5 were 30p rather than 100p because then the price would
6 be lower and more fuel would be sold.

7 So in general, acquirers are probably on balance
8 keener on the lower interchange fee than on the higher
9 one, and that's why in these committee discussions, as
10 we have heard, usually it is the acquirers who say,
11 well, keep the interchange fee -- don't put it too high.

12 But individual acquirers are a bit I think genuinely
13 more indifferent when it comes to choosing between
14 schemes because it is not directly their bottom line, it
15 is much more on the issuing side of the bank, say a bank
16 is an acquirer and an issuer, that the bank has to
17 choose between the two schemes.

18 MR SMITH: Thank you very much, Dr Niels.

19 MR JUSTICE BARLING: Sorry, Mr Brealey.

20 MR BREALEY: No. Very interesting.

21 I'm not sure I have got any questions out of that.

22 Thank you very much.

23 We were talking about the MIF. So we went from MIF
24 to bilateral. If we can come back to MIF, and I took
25 you to the ECJ and you had a look at the MIF

74

1 specifically, correct? And we were looking at whether
2 the scheme creates benefits, and I think you said
3 something like, well, the MIF is necessary for the
4 scheme to produce the benefits. Does that ring a bell?
5 That you have to wrap up the MIF and the scheme in order
6 to --

7 A. Yes, to get those benefits from the four-party schemes.
8 Yes.

9 Q. Again, it may be a legal analysis, but it is still quite
10 important for where your report is coming from. Can
11 I ask you to go to bundle E3.10, which is the Deloitte's
12 survey, tab 202, page 4307, which gives a fairly neat
13 summary of at least the Commission's analysis of what
14 you should be looking at.

15 A. Yes.

16 Q. I'm particularly interested in paragraphs 50 to 54.

17 Again, this is in the context of we know from the
18 ECJ that the wrong question is whether the scheme
19 produces the benefit. We are now looking at what you
20 regard as a relevant question, which is that the MIF and
21 the scheme are all wrapped into one to create the
22 benefit.

23 Essentially what you were saying is that without the
24 MIF, the scheme won't exist. I mean, it could not
25 compete. And that's where you were coming from, yes?

75

1 A. Yes.

2 Q. So this is how at least the Commission analyses it.

3 At paragraph 50 we get the normal prohibition on
4 agreements which distort competition. Then at
5 paragraph 51:

6 "In the MasterCard, the Commission concluded that
7 the cross-border MIF infringed by creating the de facto
8 floor and restricting the competitive interaction
9 between acquiring banks."

10 That relates what I described in opening to the
11 three anti-competitive vices. So you have the
12 collusion, you have the anti-competitive vices in 51.

13 Then at 52:

14 "A restriction of competition may...(Reading to the
15 words)... for the existence of an agreement of that
16 type."

17 That's essentially what you are talking to.

18 "In MasterCard, however, the Commission concluded
19 that a collective mechanism that shifts costs between
20 acquiring and issuing banks is not indispensable for the
21 operation of a four-party scheme because issuing banks
22 and acquiring banks can recover their costs directly via
23 their respective customer group. Indeed, the MasterCard
24 decision identified five comparable payment card schemes
25 that successfully operate in different member states

76

1 without a MIF."
 2 Just pausing there. Do you disagree with
 3 the Commission's analysis there?
 4 A. I disagree with the Commission's analysis there.
 5 Q. Then going on to paragraph 53:
 6 "Although a MIF is not necessary for the operation
 7 of a four-party payment scheme, in principle some MIFs
 8 may enhance the efficiency of a scheme and benefit its
 9 users. According to 101(3), restrictive agreements
 10 [that is the MIF here] that are caught by 101 are
 11 nevertheless valid if they contribute to improving ..."
 12 And it sets out the conditions for 101(3).
 13 Then 54:
 14 "The MIF is an instrument that shifts the costs."
 15 Then it talks about balancing, but then it also
 16 talks about:
 17 "If you are going to claim these efficiencies, it
 18 must be based on robust and compelling analysis that
 19 relies...(Reading to the words)... the relevant
 20 consumers to consider for analysis of efficiencies on
 21 merchants and their subsequent purchasers."
 22 Assuming that you are wrong on paragraph 52 and that
 23 you can have a four-party scheme without a MIF --
 24 I think that then deals with your point about how you
 25 have to wrap up the MIF and the scheme -- do you then

1 accept that you have got to look at the MIF specifically
 2 to determine whether there are efficiency gains under
 3 article 101(3)? In other words, forget the fact that
 4 the MIF and the scheme are wrapped up into one, do you
 5 accept that you have to look specifically at whether the
 6 MIF produces the efficiency gain?
 7 A. Yes, I agree.
 8 Q. That was the first condition.
 9 Can we go on to the second condition now of
 10 article 101(3). To do that -- you probably want to put
 11 those bundles away -- we will need bundle E1. I don't
 12 know if you have E1 there.
 13 Just coming back to the evidence you gave a moment
 14 ago about why you disagreed with the Commission on the
 15 necessity for the MIF, if the EU regulators had reduced
 16 the MIF to zero, banned it completely, both Visa and
 17 MasterCard, would you say that the two schemes would
 18 collapse?
 19 A. I think they would struggle in the competition with Amex
 20 and other three-party schemes that may arise. So in the
 21 hypothetical situation, you are saying if the -- well,
 22 the EU regulator, but also any MIF was zero, so also the
 23 UK MIF. Is that what you are --
 24 Q. Yes, I'm saying that let's assume the UK regulator or
 25 the UK Government said Visa and MasterCard can't have

1 a MIF. Amex can, but they can't.
 2 A. Yes, my position is they would both -- both schemes
 3 would certainly lose a lot of market share to
 4 three-party schemes. I don't know where it would end up
 5 ultimately.
 6 But also the competitive situation would be a lot
 7 worse, I think. So competition in the interscheme
 8 market would be a lot worse. Competition in the issuing
 9 market would be a lot worse. Looking at it in the
 10 round, I wouldn't say it is a more desirable competitive
 11 outcome, that situation.
 12 Q. But would they collapse? The competitive outcome is
 13 a completely different matter. Would they collapse?
 14 Are they absolutely necessary for the operation of
 15 a four-party scheme, that is the test?
 16 A. They may collapse. You don't know where it ends up.
 17 Certainly if they exist in their current form they may
 18 avoid collapse by actually making changes to the nature
 19 of the scheme. In essence they could, from credit
 20 cards, try to become debit cards. In my mind that's not
 21 a very informative counterfactual, but those kinds of
 22 things are possible in the world where both of them had
 23 to set a zero MIF.
 24 Q. If we go to E1, tab 2A, these are the guidelines from
 25 the European Commission. Again, MasterCard has referred

1 to these in the skeleton, so I take it that they are not
 2 in dispute. But I need to take you to them to see how
 3 you have approached your economic evidence.
 4 You are familiar with these guidelines, I take it?
 5 A. Yes.
 6 Q. And we will come to them a bit later on on other
 7 matters, but if we go to paragraph 38, for example,
 8 38A.7, so page 38A.7, this is at the start of the
 9 principles of the application of article 101(3). Some
 10 of them you have already accepted because they are in
 11 the Commission's decision.
 12 If we go over the page at 38A.8, we have the first
 13 condition, and we will see there at paragraph 50 and 51
 14 those same efficiency claims.
 15 So at 51:
 16 "All efficiency claims must be substantiated."
 17 And we get again the nature of the claimed
 18 efficiencies, the link between the agreement -- here the
 19 MIF -- and the efficiencies, the likelihood of
 20 magnitude, how and when. So this is where
 21 the Commission is talking about the efficiencies.
 22 If we then jump to paragraph 83, this is what I want
 23 to ask you about, which is page 38A.13:
 24 "According to the second condition of
 25 article 101(3), consumers must receive a fair share of

1 the efficiencies generated by the restrictive
 2 agreement."
 3 You accept that, of course?
 4 A. Yes.
 5 Q. Then it gives at 84 what is meant by "consumers", but
 6 I want to ask you about 85:
 7 "The concept of fair share implies that the pass-on
 8 of benefits must at least compensate consumers for any
 9 actual or likely negative impact caused to them by the
 10 restriction of competition found under article 101(1).
 11 In line with the overall objectives to article 101 to
 12 prevent anti-competitive agreements, the net effect of
 13 the agreement must at least be neutral from the point of
 14 view of those consumers directly or likely affected by
 15 the agreement."
 16 And it sets out the authority for it.
 17 "If such consumers are worse off following the
 18 agreement, the second condition of article 101(3) is not
 19 fulfilled."
 20 Now, that is based on the court's jurisprudence. Do
 21 you accept that that is how you have approached your
 22 report?
 23 A. I accept that this is the criterion, how one looks at
 24 fair share. As I said earlier, there are inherent
 25 limitations as to how precise one can get in this -- the

81

1 restriction and does it fully compensate.
 2 I think my analysis overall -- so to start with,
 3 I don't actually think there is a restriction of
 4 competition, for reasons I won't go into now, but that
 5 sort of is a starting point. But there are clearly
 6 efficiencies, as we have also established. And I think
 7 merchants benefit as well as pay this higher cost from
 8 the cost shifting and interchange, but merchants
 9 benefit. And I think both methods to come up with
 10 an exemptable level of MIF. So the cost-based method
 11 and the MIT-based method tried to capture the notion of
 12 merchant benefits.
 13 I know it is a bit of a round about way of getting
 14 there, but I think once you accept that the number that
 15 comes out of the method, you call that the exemptable
 16 MIF, and inherent in that is the fact that merchants in
 17 their benefit as well, because merchant benefits do come
 18 in explicitly under both methods.
 19 Q. Then at paragraph 87, again I do not think it is
 20 controversial because it is supported by authority, but
 21 I just want to ask you whether you have adopted this in
 22 your report.
 23 At paragraph 87, the first sentence:
 24 "The decisive factor is the overall impact on
 25 consumers of the products within the relevant market and

82

1 not the impact on individual members of this group of
 2 consumers."
 3 You adopted that approach in your report?
 4 A. Well, "adopted" may be a big word, but I think I'm aware
 5 of this criterion.
 6 Q. Have you attempted to follow it?
 7 A. Yes, I have looked at the overall impact on merchants.
 8 Now, there is of course a discussion in there about
 9 individual merchants and -- so the individual benefit to
 10 merchants and the aggregate benefit to merchants.
 11 I don't think that translates one-to-one with this
 12 distinction between overall and individual because
 13 even -- the business stealing argument. I don't think
 14 that translates exactly, maps onto here exactly, because
 15 I think there is a situation where even if -- I think
 16 merchants also benefit overall because they each benefit
 17 individually despite business stealing. So this
 18 aggregate merchants where you cancel out business
 19 stealing effect. I have a whole discussion on that, but
 20 I don't think it is the same as these two criteria here,
 21 overall versus individual.
 22 I have, to answer the question more shortly, looked
 23 at what is the effect on merchants basically.
 24 Q. As a group?
 25 A. Overall, yes.

83

1 Q. That is the second condition. What do you understand is
 2 meant by the third condition?
 3 A. The indispensability?
 4 Q. Correct.
 5 A. Well, my understanding is that you have to show that
 6 the -- that bit in the agreement itself, or the
 7 agreement is --
 8 Q. The restriction --
 9 A. -- is indispensable.
 10 Q. The restriction is indispensable?
 11 A. Is indispensable to obtain the efficiencies.
 12 Q. In other words, if the efficiency would occur anyway,
 13 the transaction would occur anyway, the restriction is
 14 not necessary?
 15 A. Correct, not indispensable.
 16 Q. So in your report you have calculated the exemptable MIF
 17 in two ways, as you have said. Basically I can call it
 18 the issuer's cost methodology and the adjusted MIT
 19 approach. Yes?
 20 A. Yes.
 21 Q. Can I go first of all to the issuer's cost methodology.
 22 I think you can put all the bundles away, but you will
 23 need your first report, bundle 3, tab 3.
 24 A. Yes.
 25 Q. The exemption section, as you said earlier on, I think

84

1 starts at section 4, but this is the adjusted benefit
 2 cost balancing approach, which I will call the issuer's
 3 cost methodology. It is in section 5 at page 287.
 4 A. Yes.
 5 Q. This takes up the whole of section 5.
 6 A. Yes.
 7 Q. At 5.1 you say that the two-sided markets often exhibit
 8 skewed pricing, which I think everybody in the room
 9 would agree with.
 10 But then there is an issue between the parties as to
 11 whether this skewed pricing that results from the
 12 collective pricing arrangements is inherently
 13 pro-competitive.
 14 You then go at 5.3, where you take our famous
 15 friends, the three heads of issuer's cost. So for
 16 credit card, MasterCard, takes three heads of issuer's
 17 costs, processing costs, payment guarantee costs and the
 18 interest-free period also called funding costs, as
 19 a proxy for the cost revenue in balance.
 20 "I note that the European Commission in its Visa
 21 exemption decision of 2002 accepted these three heads of
 22 costs as benefiting merchants and forming a basis for
 23 setting the exemptable intra-EEA MIF for credit cards."
 24 Just pausing there. Why did you mention the
 25 European Commission's exemption decision?

85

1 A. Because it was a noteworthy decision at the time, in the
 2 overall context also of the OFT investigation. And what
 3 I also found noteworthy is that the solution that the
 4 European Commission came up with at the time was exactly
 5 the methodology that MasterCard had followed with EDC
 6 since the NaBANCO case in 1987.
 7 So I just mention it there. Actually, also perhaps
 8 a bit for the avoidance of confusion because there is
 9 sometimes a bit of confusion including, in some
 10 documents in this case but also in the European
 11 Commission stage, that somehow MasterCard introduced
 12 this after Visa. But the MasterCard method, or at least
 13 the cost study method, has existed since the 1980s. And
 14 what I find noteworthy, and therefore I quote it here,
 15 is it is the same three heads of cost and the Commission
 16 explicitly said that the Commission can see that these
 17 heads of cost also benefit merchants.
 18 Q. But again, with the greatest respect, Doctor, it doesn't
 19 really give a balanced impression because, as I am sure
 20 you are aware, footnote 44 of that exemption decision
 21 specifically gives a caveat on domestic MIFs. But you
 22 don't mention that?
 23 A. No, I don't. It mentions it, I believe indeed for the,
 24 if I'm not mistaken, interest-free period.
 25 Q. You don't mention the fact that there are documents in

86

1 the case where clearly the Commission, quote:
 2 "... regarded that the issuer's cost methodology as
 3 unsound and was not going to renew the Visa exemption."
 4 But you don't mention that?
 5 A. I think I mention that this was in place until 2007.
 6 I'm very well aware of it, and at that stage
 7 the Commission did not continue this method and instead
 8 favoured the other method.
 9 Q. Don't you think, just on reflection, you could have put
 10 in brackets "but I appreciate in 2004/2005
 11 the Commission no longer regarded it as benefiting
 12 merchants and that was confirmed by the Commission in
 13 its 2007 infringement decision"? It is just a matter of
 14 impression, I put to you. No?
 15 A. I don't see a particular need on that one, to be honest.
 16 Q. All right, okay. So.
 17 At paragraph 5.4, you say:
 18 "I consider the cost studies carried out by
 19 MasterCard, or rather independently from MasterCard, by
 20 Edgar Dunn & Company (EDC) to be a useful ...(Reading to
 21 the words)... for the current case. I have no reason to
 22 doubt that these cost studies have been carried out in
 23 a robust and objective manner. Indeed, I understand
 24 that they were subject to an independent audit by
 25 Ernst & Young."

87

1 There you footnote reference to the witness
 2 statement of Peter Sidenius, correct?
 3 A. Yes.
 4 Q. Then throughout this section, you refer almost
 5 exclusively on the data compiled by Edgar Dunn. I will
 6 just take you through it.
 7 So paragraph 8.15 on page 290, it starts at 5.15
 8 at 290, where you set out Edgar Dunn's credit card cost
 9 studies. This is at page 290, 5.15, and then at 5.16
 10 what they have done.
 11 And 5.18:
 12 "I understand from the witness statement of
 13 Peter Sidenius there are two studies."
 14 And you refer to the 2005.
 15 That's the first bullet. Then you refer to the
 16 MasterCard worldwide 2008 study, correct?
 17 A. Yes.
 18 Q. Then we can go on, paragraph 5.20 -- I take it this is
 19 not blue or anything?
 20 MR HOSKINS: The detailed figures are in that table.
 21 MR BREALEY: 5.20 summarises the credit card interchange
 22 cost findings, a breakdown of the main cost categories
 23 and then you set out the results.
 24 We can cut this short, but you go at 5.82, towards
 25 the end of your report, conclusions on the exemptable UK

88

1 MIF based on the Edgar Dunn cost study, a UK MIF etc:
 2 "Based on the Edgar Dunn studies for credit cards, a
 3 cost revenue balancing for credit cards would be around
 4 ..."
 5 Then you give a percentage. I don't know whether it
 6 is confidential or not.
 7 If you go over the page 5.84, 5.85 you set out a
 8 table, table 5.2. Again, the results, and the source:
 9 based on Edgar Dunn studies.
 10 Then at paragraph 5.89, again the exemptable level
 11 of UK MIF based on the 2008 study would then be between
 12 whatever it is.
 13 So it is fair to say that this whole section is
 14 squarely based on the 2005, but more particularly, the
 15 2008 Edgar Dunn cost study?
 16 A. I used the Edgar Dunn cost study as the data source for
 17 my cost-based approach. That is correct. So I rely
 18 heavily on the 2008 in particular Edgar Dunn study.
 19 You referred to the whole section. There is also
 20 a long bit in the middle of section 5 which discusses
 21 the evidence on merchant benefits which then informs me
 22 in my assessment of, okay, I take the EDC cost data as
 23 given and as a starting point, and then I form my own
 24 view on how to allocate that to -- into a MIF with
 25 an eye on what's the evidence on merchant benefits.

89

1 Q. Staying on 5.89 then, we have, with greatest respect,
 2 a very long passage about the cost studies. And then
 3 the punchline, as it were, is at paragraph 5.89 where it
 4 says:
 5 "Given the important benefits that merchants derive
 6 from these costs, it would be reasonable but
 7 conservative to attribute at least 25% or 50% of these
 8 costs to merchants."
 9 So before we get to the costs themselves the
 10 punchline is that one paragraph, and on what basis does
 11 any reader get from this as to why you consider it would
 12 be reasonable to attribute a quarter or a half of these
 13 issuer's costs to merchants? What is the basis for it?
 14 A. Yes. So as I have set out in the paragraph above that,
 15 we have these costs and we have evidence on merchant
 16 benefits. One has to take a view. It is clear one
 17 can't -- there are no hard and fast lines here, but I'm
 18 giving my view on this evidence.
 19 I think it would not be right to attribute all of
 20 those costs of credit write-offs to merchants because
 21 clearly also cardholder benefits. So there is
 22 an element of judgment here on the fair share. But nor,
 23 importantly, do I consider it correct to say none of
 24 these costs should be included because none of them
 25 benefit merchants.

90

1 In my analysis, clearly these costs do benefit
 2 merchants. And then it is a matter of judgment, but
 3 actually in my table 5.2 I showed the whole range. So
 4 at the end of the day it is perhaps not for me to come
 5 up with the right judgment, but I'm showing in my
 6 table 5.2 what the resulting exemptable level of MIF
 7 would be under different weights you give to the extent
 8 to which merchants benefit.
 9 So, in my view, indeed I cannot do more than say
 10 zero would be too extreme, 100 might not be right
 11 because cardholders benefit, so let's be conservative
 12 and say it is between 25% and 50%. That to me is
 13 a reasonable number.
 14 Q. I think the Tribunal would understand that, that that is
 15 your estimate of what is reasonable. But what is it
 16 based on?
 17 A. It is based on the logic I have just set out. There is
 18 strong, convincing evidence in my mind that merchants
 19 also benefit from the credit extension, the extension of
 20 credit and the interest-free period to cardholders. And
 21 therefore, the logic of this cost base method is to look
 22 at three heads of issuer cost that also benefit
 23 merchants, and then it just comes down to a question,
 24 well, to what extent do they benefit merchants?
 25 And one has to come up with a value judgment there.

91

1 That's as far as I can go, is to give my judgment at 25%
 2 to 50% is conservative. There is at that stage no hard
 3 and fast rules to draw the line somewhere, but I am
 4 clear that it shouldn't be zero.
 5 MR JUSTICE BARLING: Is that a convenient moment for a short
 6 break?
 7 MR BREALEY: It is.
 8 (3.17 pm)
 9 (A short break)
 10 (3.27 pm)
 11 MR BREALEY: If we could go back, what have you got there?
 12 D3?
 13 A. Yes.
 14 Q. If you go back to paragraph 5.4, which we saw a minute
 15 ago, it is the last sentence of 5.4:
 16 "I have no reason to doubt these cost studies have
 17 been carried out in a robust and objective manner.
 18 I understand they were subject to an independent audit
 19 by Ernst & Young."
 20 Now, that may be true but do you accept that these
 21 cost studies are not robust for you to undertake
 22 a calculation for these proceedings?
 23 A. No, I don't accept that. I think this is -- to me this
 24 is robust and relevant evidence. This is after all the
 25 method that has been in place for more than 30 years,

92

1 and the people carrying it out have a lot of experience
 2 carrying it out.
 3 As I said, I have no reason to doubt that these
 4 numbers are robust and objective, and therefore I feel
 5 I can rely on the outcome of the studies.
 6 Q. But you consider that they would be sufficiently robust,
 7 for example, to calculate a MIF for 2010?
 8 A. Yes, 2010 still. If you are referring to the time
 9 period -- is that the question? It is 2010 as opposed
 10 to 2008, is that the question?
 11 Q. As you probably know -- have you read the transcript of
 12 the evidence of Mr Sidenius?
 13 A. Yes, I was here that day.
 14 Q. So let's just remind ourselves of what he said. Let's
 15 have a look at the 2008 cost study and what he said.
 16 So the cost study is at bundle E3.6, tab 126. Let's
 17 familiarise ourselves with the document. You will also
 18 need the transcript bundle, J2, tab 11 at page 1390.
 19 That's page 19 of the transcript, tab 11.
 20 A. Yes.
 21 Q. First of all, to identify the document, this is the
 22 document that you relied on as evidence to give your
 23 opinion on the level of MIF that should have been
 24 payable from late 2006 to today.
 25 A. Yes.

1 Q. Did you look at any underlying documents or did you just
 2 accept what Edgar Dunn had done?
 3 A. I did not look at underlying documents of Edgar Dunn.
 4 So I relied mainly on this document itself and then
 5 my understanding of the method which had come across
 6 before.
 7 Q. Let's see what Mr Sidenius said about the robustness of
 8 this data for use over such a period of time. How many
 9 years are we talking about?
 10 A. So we are talking here about a damages period of nine
 11 years, end of 2006 to -- or end of last year.
 12 Q. So at page 1390, page 19 of the transcript, so I asked
 13 the question it is dated 2008, probably relates to 2007
 14 data.
 15 It is line 7:
 16 "Answer: That is correct."
 17 That is at paragraph 35.1 of his statement. There
 18 was -- it was a January 2006/2005 study:
 19 "Question: ... Would that have related to 2004 data
 20 or 2005 data?"
 21 He says:
 22 "Answer: The 2005 report would have been 2004 data
 23 ..."
 24 So I asked the question in line 15:
 25 "Question: So why are you updating the data? One

1 is 2004, one is 2007. Why are you updating it?
 2 "Answer: Because -- you are asking a question that
 3 goes back nearly 40 years in time ..."
 4 Then he goes on, and I let him go on, if you
 5 remember, about the NaBANCO case, which is fair enough.
 6 But then we get to page 1392, so page 21 of the
 7 transcript.
 8 At line 7:
 9 "So every time you wanted to revisit on a periodical
 10 basis the interchange in the market to ensure it was
 11 correct, there would be a requirement to undertake
 12 a cost study."
 13 This is his evidence:
 14 "Answer: So from Edgar Dunn's perspective that is
 15 where our methodology originated from. We looked at if
 16 there is an imbalance in the card payment system, it
 17 must because there is probably something on the issuing
 18 side that is of value to the acquiring side. We tried
 19 to quantify those; we came up with the methodology we
 20 currently apply.
 21 "Whenever this methodology was applied in the given
 22 market we believe, and we strongly advised our clients,
 23 that it would be wise to apply this periodically to
 24 update the numbers to ensure you were in line with the
 25 market. Because there would be things that are changed,

1 such as interest rates in the market, so the cost of
 2 funds, the bad debt, the fraud, these things need to be
 3 updated periodically to ensure you are in line with what
 4 happens."
 5 So I said.
 6 "Question: The last point you just made, which
 7 seems to be a very valid point, why is it that the last
 8 Edgar Dunn cost study is 2008? Why hasn't there been an
 9 update?
 10 "Answer: That was because of the European
 11 Commission case and the OFT at that stage basically
 12 stating that they did not believe the application of the
 13 methodology was correct anymore, and therefore
 14 MasterCard deemed that it would be -- there was no value
 15 in undertaking a cost study that would be rejected
 16 immediately.
 17 "Question: And that's the reason you did not do
 18 a further one?"
 19 I asked.
 20 "Answer: Yes.
 21 "Question: But had they not intervened, you would
 22 have advised your clients strongly to update the cost
 23 studies?
 24 "Answer: Yes. That would have been very nice for
 25 us as well.

1 "Question: If I was doing a calculation for an
2 interchange fee today, I would not be relying on this
3 cost study because, as you say, interest rates change
4 and all that sort of stuff?
5 "Answer: I would agree.
6 "Question: In fact, it would be rather foolish to
7 calculate an interchange fee based on this cost study?
8 "Answer: Yes, I think it is outdated."
9 What is your reaction to that?
10 A. My reaction is that it is indeed somewhat
11 unsatisfactory. We have a nine-year damages period and
12 for the cost based method we have data for one year. As
13 it happens, it is the first full year in the period.
14 Ideally, one would have liked more data and this is
15 then for the exemptable level of MIF and for the damages
16 calculation.
17 A similar thing to be said for the other methods,
18 the MIT, where the only proper or decent data source
19 that they are using is the 2015 EC merchant cost study
20 which has data for 2013. Again, not entirely
21 satisfactory that you don't have data going all the way
22 back from 2007.
23 Q. Sorry, Dr Niels, I just want to interrupt. As you know
24 Mr von Hinten-Reed has tried to analyse the data going
25 back some years, correct?

97

1 A. But only Sainsbury's specific data, that's why I said
2 the only proper source is the EC merchant study, which
3 is the survey of many merchants.
4 Q. I am concentrating on the robustness of what you have
5 relied on. The reason for that is it is MasterCard's
6 burden of proof to prove an exemption. It is not for
7 Sainsbury's to prove any exemption. So I need to know
8 from you whether you accept that the data you have
9 relied on is robust and convincing for the purposes for
10 which you have used it?
11 A. Yes, and I think it is. So what I'm saying is this is
12 again both for exemptable level and for the damages
13 calculation. I accept it is somewhat unsatisfactory
14 that for both methods you have only one year of data.
15 Ideally one would have liked more. But nonetheless
16 I think -- well, I certainly still rely on -- sticking
17 with the cost study, I still rely on that cost data. It
18 gives a good indication of what it costs -- what costs
19 would have been in those years.
20 I was not in a position to redo or update the cost
21 studies, so this was the best available data. I did
22 look a little bit into, well, if these costs move, as
23 Mr Sidenius has signalled, what direction would they
24 have moved? As I flagged up in section 3 of my report,
25 if you look at the biggest cost item in there, which is

98

1 the credit default cost, I don't think that's
2 confidential, I flagged it in section 3 of my report.
3 I referred to data from the FCA, that between 2007 and
4 2010 those default costs went through the roof, I mean,
5 record levels.
6 So that tells me that if anything, in the subsequent
7 years the total costs that Mr Sidenius would have
8 produced would have gone up. But that is as far as
9 I can go. I accept that I have not updated, or I was
10 not in a position to update the 2008 cost study.
11 Q. Let's take this in stages. Keep the bundles open, but
12 can you go to bundle E2, please, tab 6. This is
13 a MasterCard document. We have seen it before. It has
14 attached to it a report, an economic analysis by
15 Professor Weizäcker, and that starts at 362. This is
16 the MasterCard notice of appeal 2005.
17 It has an economic analysis of the MIF at 362, which
18 is a similar sort of thing that you are calculating. If
19 I go to 380, paragraph 92 he says -- this is the
20 Professor. This is the basis upon which he is relying
21 on robust data from Edgar Dunn:
22 "The starting point for setting the default MIF is
23 to take into account those costs which reflect a
24 conservative estimate ...(Reading to the words)...
25 providing a payment guarantee."

99

1 The very same costs that you are dealing with.
2 93:
3 "These costs are determined by a cost study
4 performed every second year by a specialist independent
5 firm of consultants."
6 Edgar Dunn & Company, the EDC cost study.
7 So it is MasterCard's own view that these cost
8 estimates have to be, or should be updated every second
9 year for the very reasons that Mr Sidenius gives in his
10 evidence, both in answer to a question that I posed and
11 both in answer to a question that Mr Justice Barling
12 posed, that things change. You accept that.
13 I think you have accepted that it is unsatisfactory
14 that you are relying on 2007 data to calculate a MIF for
15 a nine/ten-year period. You have accepted it is
16 unsatisfactory?
17 A. Yes, it is unsatisfactory, but I still rely on the
18 results. What I don't know from here is one implication
19 of the question is MasterCard did this every second
20 year. I can't recall. What I have seen is the cost
21 studies in 2005 and 2008. So that is three years.
22 I don't know factually whether Professor Weizäcker
23 is correct here, but clearly, yes, there was a need to
24 do this periodically. I can see the commercial
25 rationale for that.

100

1 Q. If it is unsatisfactory, how on earth can it be robust
2 and compelling?
3 A. It is robust for that period and also for the years
4 immediately after that. So it is robust data to start
5 with, the cost study.
6 Then the only reason why one may doubt it is that
7 these costs can move over time, and I accept that and
8 that is the bit that is unsatisfactory. Nonetheless, is
9 my answer on what's the reasonable and exemptable level
10 of MIF wrong?
11 I think, in any event, I do not think I'm
12 overestimating the MIT for this reason because for the
13 reason that I outlined earlier, if anything, we saw the
14 cost of default, which is by far the biggest cost item
15 here, would have gone up certainly in the next four
16 years. It may have gone down a bit. But -- so on that
17 basis, that for me is sufficient to conclude that I'm
18 not -- I'm certainly not overestimating the MIF on this
19 basis.
20 So unsatisfactory, but I think I can still rely on
21 this as a reasonable conservative measure of what comes
22 out of a cost study.
23 Q. This is a piece of evidence that you refer to which is
24 not in section 5 at all, is it? This is just something
25 that you have highlighted in your report about default.

101

1 There's no analysis in section 5 about this at all?
2 A. Correct. I have not carried out an analysis trying to
3 assess what the cost would have been like.
4 Q. No.
5 A. So I'm deriving this based on what I said in section 3
6 of my report. That's correct.
7 Q. For example, I could put to you that the LIBOR rates
8 have gone from whatever it was, 6% to 0.6%, and so the
9 cost of the banks' borrowing for the 28 free credit was
10 gone down, for example. I could put that to you?
11 A. For example, the free funding costs would have gone down
12 and they are a much smaller component, but that is one
13 component that could have gone the other way.
14 Q. I can also put to you, although me putting it to you is
15 that the average APR on credit cards has actually gone
16 up over the claim period?
17 A. That may well be the case, I don't know. But that's not
18 an item that goes into the cost study.
19 Q. We are going to come on to that in a moment.
20 Were you in court when Mr Cook was cross-examining
21 Mr Reynolds yesterday?
22 A. No.
23 Q. Well, it was put to Sainsbury's that the period of the
24 claim was probably one of the most turbulent periods in
25 the financial history for the best part of 60/70 years.

102

1 Would you accept that? We have had the eurozone crisis,
2 we have had the banking crisis, would you accept it has
3 been a bit turbulent?
4 A. Yes, I accept that.
5 Q. Yet you still don't think that you would need to revisit
6 data that relates to 2007?
7 A. Ideally one would like to revisit the data. I was not
8 in the position to do so. And again, I don't think my
9 analysis -- my resulting -- my resulting number from the
10 cost study overestimates the MIF because on balance
11 I would posit, but I haven't analysed it in detail,
12 I accept, that costs would have gone up because of these
13 turbulent times. In particular, the --
14 MR JUSTICE BARLING: The defaults.
15 A. The defaults, yes.
16 MR JUSTICE BARLING: You say what you did was conservative,
17 on balance?
18 A. Yes.
19 MR BREALEY: Can we go to bundle E1, please. Just out of
20 interest, where in D3 do you refer to this, so the
21 Tribunal have it in mind?
22 A. I will find it. It takes me a while.
23 Q. If you find it, we can revisit it maybe tomorrow.
24 PROFESSOR JOHN BEATH: The use of the term "conservative"?
25 A. No. The --

103

1 MR BREALEY: I think it is 378, is it? 379?
2 A. In 379 I refer to the cost of defaults. So the FCA
3 study or data showing the defaults have risen. That's
4 what I referred to earlier. This is in the overall
5 discussion as to -- about issuer costs, why they are
6 higher in the EU than other ...
7 MR JUSTICE BARLING: Forward losses. That's fraud. 3.6 is
8 fraud, isn't it?
9 A. Correct.
10 MR JUSTICE BARLING: So that was very high --
11 A. So fraud has gone down.
12 MR JUSTICE BARLING: That's gone down.
13 MR BREALEY: Sorry, which paragraph are you referring to?
14 A. In 380, and in the chart you can see that fraud cost
15 would have gone down somewhat.
16 MR JUSTICE BARLING: Do you have a similar table for default
17 costs?
18 A. No, I don't. I just mention it qualitatively in 379.
19 MR BREALEY: The only evidence that we have got before the
20 Tribunal is 379:
21 "The result of an increase in the number of bad
22 debts."
23 At E1, tab 15, again it is the General Court.
24 Page 345, just after the page we were looking at before,
25 starting at 209 to 211. I would imagine you have been

104

1 taken to these three paragraphs because I have referred
2 certain witnesses to them. It relates to interest.

3 The second assumption is that issuing banks bear the
4 majority of the costs of the system. Do you see that?
5 Yes?

6 A. Yes.

7 Q. You must have read this before?

8 A. I have, yes.

9 Q. So the second assumption is the issuing banks bear the
10 majority of the costs of the system. As you know,
11 the Commission said that issuers' revenues had to be
12 taken into account. That was apparently appealed, and
13 the General Court said:

14 "With regard to the second assumption, as
15 the Commission has pointed out, in essence recital 686,
16 it is sufficient to note that it is based on a partial
17 presentation of the issuing and acquiring business,
18 taking into account only the costs borne by the issuing
19 banks and omitting the revenues or other economic
20 advantages they obtain from credit card issuing business
21 notwithstanding the latter's importance."

22 See paragraphs 106 to 108.

23 106 to 108 is at page 332, which relates exclusively
24 to the UK market, as you have probably seen.

25 So we established this morning that you looked at

105

1 the judgments of the courts to guide your economic
2 analysis. The question that I'm sure you know I'm going
3 to ask is why have you not taken into account the
4 substantial interest that banks earn, and other economic
5 advantages from credit cards?

6 A. I think, well, there is various angles to this. I think
7 this particular point here in 211 is a criticism of the
8 cost method that I think misses the point because there
9 is a justification for the cost method despite it not
10 explicitly accounting for issuer revenue.

11 I can go through the justification of the cost
12 method and I can go through the question of revenues as
13 to why or -- in what context they are or are not taken
14 into account. Because I think it is a bit too -- it is
15 a bit cutting corners to say the cost method doesn't
16 directly incorporate revenues because that is correct.
17 But that misses the point of why a cost method is
18 justified.

19 I think it goes back to the principles. If we are
20 in 101(3), exemptable level of MIF or the damages
21 calculation, so what would be a reasonable exemptable
22 level of MIF? In general, when you want to sort of
23 regulate a product or determine a fair price, there are
24 two main ways of doing it. One is to look at the
25 product's costs and the other is to look at the price of

106

1 benchmark or comparable products.

2 So my cost-based method is looking at cost, and
3 that's not uncommon in regulation. Most utility
4 regulation is cost based. The MIT method which I also
5 applied is more looking at the benchmark price. So that
6 criticism, looking at cost doesn't take into account
7 revenues, I do not think it is a valid one at that
8 level.

9 On the issuer revenue question, clearly issuers also
10 make revenues, but the whole principle of interchange,
11 so going back to Baxter and also then the EDC cost
12 methodology, is even taking into account those issuer
13 revenues, so you look at all the revenues on the
14 merchant side, the costs on the acquiring side, you look
15 at all the revenues from the cardholders and the costs
16 to the issuers, even then you have an imbalance in this
17 four-party system. So despite the issuer revenues. And
18 the MIF is a mechanism to allocate that.

19 So from that perspective, from the origins of the
20 cost, even the cost method being a proxy for the
21 imbalance does take into account issuer revenue from
22 that perspective.

23 Q. But --

24 A. Let me then continue on the issuing revenue because it
25 is a big theme.

107

1 You can look at this in three stages. Conceptually,
2 empirically, what is actually the evidence on issuer
3 revenue, and normatively, should issuer revenues be the
4 be all and end all.

5 Conceptually, in a two-sided market a scheme may
6 decide, look, there is a pot of money to be had from
7 merchants, on the merchant side and from cardholders,
8 and let's suppose the optimal, like any two-sided market
9 you get the skewed pricing structure, so let's suppose
10 it is right that we charge this to merchants, this
11 amount, this MSC of 1%, say. Amex does that, the
12 four-party scheme wants to do it as well.

13 So there is a pot of revenue on the merchant's side,
14 and clearly there are revenues on the cardholder's side.
15 But there is no -- that is the balance of the scheme,
16 and then you look at cost and revenues and you find,
17 okay, with this level of revenues on the merchant's
18 side, acquirers actually getting a good deal out of this
19 and that's not the right balance within the system. So
20 let's reallocate through the MIF.

21 Because you shouldn't forget that, yes, issuers get
22 roughly -- I don't know if this is now confidential --
23 between 70% and 80% of the scheme's revenues are on the
24 issuing side. So that is the issuer revenue. The rest
25 is on the merchant's side. But -- maybe this is

108

1 confidential -- we saw the percentage of costs, and more
 2 than 95% of the costs are incurred on the issuing side.
 3 So the issuers have 95% of the cost and 70%, 80% of the
 4 revenue, so there is an imbalance.
 5 Conceptually that's where a MIF comes into play.
 6 Then I think the argument from the other side is: but
 7 those issuer revenues in their own right, might they be
 8 big enough, even if you have an imbalance, forget about
 9 that, might they actually be big enough to fund all
 10 those issuer costs? So are the issuers making a lot
 11 of -- getting all of that revenue and actually the
 12 scheme can function just by the issuers paying for their
 13 own costs?
 14 I think, first of all, there is no evidence, as was
 15 also established with Mr Sidenius. So no one has ever
 16 really fully analysed, well, how profitable is issuing?
 17 But from the FCA document, and we may come to it in more
 18 detail, but that was published in November last year, so
 19 after the expert reports, but one does get a clear
 20 impression that there is a lot of competition on the
 21 issuing side, including competition on the interest
 22 rate. You get lots of these zero balance transfers, low
 23 rate offers etc.
 24 That to me suggests that, yes, it is profitable on
 25 the issuing side but not so profitable that you can fund

109

1 the entire, basically the entire scheme cost. And the
 2 FCA also concluded that there is no indication that
 3 currently there is a cross subsidy from -- so interest
 4 revenues from revolvers to transactors in the scheme.
 5 My third point, apologies for the length, but
 6 normatively one would also raise big question marks. Is
 7 it even desirable to have a scheme where everything is
 8 funded out of issuer revenues? For the scheme it
 9 probably wouldn't be desirable. It is not the business
 10 proposition that 40% of all cardholders who are
 11 revolvers fund the entire thing. It is also not clear
 12 whether a scheme like that would survive in competition
 13 with other schemes.
 14 Secondly, again, from reading the FCA, the FCA as
 15 a regulator would be quite worried about a scheme that
 16 subsidises the whole scheme out of 40% of cardholders
 17 who are revolvers.
 18 So that is my take, if you like, on interest
 19 revenues.
 20 Q. Let's just try and draw this to a close, then. Do you
 21 accept or do you disagree with what the General Court
 22 has said, that when you are looking at the issue of
 23 whether issuing banks bear the majority of the costs of
 24 the system, which is the thrust of almost the whole of
 25 your report, that the issuing banks bear the majority of

110

1 the costs of the system? Do you disagree with what the
 2 General Court said, or do you accept that when looking
 3 at that you should include, or not exclude or not admit
 4 from your consideration the interest payments and the
 5 other revenue? In other words, do you agree with what
 6 the General Court has said, or disagree?
 7 A. I think it is not out of -- it is out of -- in a way
 8 I disagree therefore, is the answer, because the cost
 9 method is what it is. It is a cost method. It doesn't
 10 directly take into account issuer revenues.
 11 If the court is saying you should also look at
 12 issuer revenues, well, the answer to that is then there
 13 is another method, maybe we are then back into the
 14 overall, the fallbacks studies that EDC has also done
 15 where it did try to look at all revenues, all costs and
 16 at that imbalance. And that's where we got those
 17 percentages from, the 70%, 80% of costs on the issuing
 18 side -- sorry, 70%, 80% of the revenues, but 95% of the
 19 costs, and hence there is an imbalance taking into
 20 account issuer revenues.
 21 Q. Just, again, you have said I think in evidence that you
 22 disagree with what the General Court has said. I'm
 23 looking at section 5 of your report. Is it correct to
 24 say that you have omitted from your analysis in
 25 section 5 any analysis of revenues and other economic

111

1 advantages issuers obtained from their card issuing
 2 business? Have you omitted revenues and other economic
 3 advantages that card issuing businesses obtain in your
 4 analysis? Have you omitted it?
 5 A. Yes, in the sense that section 5, I apply a cost method
 6 as a way of getting to an exemptable level of MIF. And
 7 interest revenues do not feature in the cost method.
 8 I think I do give the rationale for the cost method,
 9 which is the rationale I explained earlier, that it is
 10 in a way -- it tries to be a proxy for also this cost
 11 revenue imbalance.
 12 But I did not look at issuer revenue explicitly in
 13 section 5, correct.
 14 Q. Would you accept with me it is rather unsatisfactory
 15 that you are giving your rationale for that halfway
 16 through this trial in cross-examination rather than in
 17 section 5 of your report?
 18 A. No, I disagree. I think there is a good rationale which
 19 I explain for the cost for doing a cost study and for
 20 doing a MIT, which -- the MIT approach which
 21 the Commission has been emphasising, which incidentally
 22 also does not explicitly look at issuer revenues because
 23 it has a completely different basis. It is a price --
 24 cost benchmarking exercise. It also doesn't look at
 25 interest revenues.

112

1 Q. Are you still in bundle 3, tab 3? Your first report.
 2 A. Yes.
 3 Q. You can clear your decks and just retain your first
 4 report.
 5 If we go to page 293, this is a section of this
 6 issuer's cost methodology where you refer to merchant
 7 benefits, correct?
 8 A. Yes. 5C.
 9 Q. Then over the page, at 5C.2 you refer to the conceptual
 10 framework, yes?
 11 A. Yes.
 12 Q. I'm interested in paragraph 5.36, where you say:
 13 "Merchants may benefit from accepting payment cards
 14 in two main ways."
 15 Then the first bullet point is a reduction in
 16 transaction costs and risks which, certainly insofar as
 17 transaction costs, Mr von Hinten-Reed accepts.
 18 Then the big difference between the two of you is
 19 the increase in sales. You would accept that that is
 20 a big difference not only between you and
 21 Mr von Hinten-Reed, but you and the European Commission?
 22 A. Correct.
 23 Q. Again, if you read 5.36:
 24 "Merchants may benefit from accepting payment cards
 25 in an increase in sales."

113

1 Just pausing there.
 2 That is the exam question that you are postulating:
 3 "Merchants may benefit from accepting payment cards
 4 in an increase in sales."
 5 The first point I want to ask you is: is that not
 6 the wrong question? The correct question is whether the
 7 MIF leads to an increase in sales.
 8 A. Yes. But then I refer back to my earlier logic that it
 9 is the MIF that enables these four-party schemes to be
 10 competitive in the first place, and therefore the
 11 benefits from cards can also be attributed to MIF.
 12 Without -- another way of putting it, and I think
 13 this is accepted logic, with a lower MIF a scheme is of
 14 less size, and therefore the bigger a scheme is, the
 15 bigger these -- you get -- the bigger these benefits
 16 also in terms of increasing sales.
 17 Q. So you take my now famous little restaurant in
 18 Tottenham.
 19 A. There is a game there tonight, I believe.
 20 Q. I'm sadly not going. If you take my little restaurant
 21 in Tottenham, are you really seriously suggesting that
 22 that restaurant in Tottenham is going to lose sales
 23 because the MasterCard credit MIF has been reduced
 24 from 0.8% to 0.3% as a result of the regulation?
 25 A. I'm not sure my analysis applies that linearly. I would

114

1 certainly say the restaurant in Tottenham benefits from
 2 the fact that it accepts MasterCard. It would benefit
 3 from accepting Amex or Visa. It benefits by offering
 4 a better service.
 5 The MIF, to bring the MIF in, means the MIF has
 6 meant -- a higher MIF has meant more people have
 7 a MasterCard so more usage, and therefore this benefit
 8 that the restaurant in Tottenham gets in accepting the
 9 MasterCard is bigger than if the MIF was lower and the
 10 MasterCard scheme was correspondingly smaller.
 11 Q. I will ask the question again. Nearly everybody in the
 12 UK, adult -- there is information on it -- most people
 13 have two, maybe three cards, debit cards, credit cards,
 14 whatever. Again, where does the small restaurant get
 15 an increase in sales as a result of the difference in
 16 level between 0.3% and 0.8%?
 17 A. Well, in general terms, first of all, let's say if the
 18 restaurant didn't accept any MasterCard then it would
 19 miss the custom of people who have a MasterCard card and
 20 want to pay with their MasterCard --
 21 Q. Forget the card.
 22 A. With a higher MIF the MasterCard scheme would be bigger
 23 because it would be more competitive, more attractive to
 24 be issuing, and therefore there is a -- it is not
 25 linear, I would say, but there is then also

115

1 a relationship with the benefits.
 2 So a scheme with a higher MIF, more card
 3 penetration, more usage, therefore is of more benefit to
 4 the merchant or to this restaurant than the scheme that
 5 has fewer cardholders because it has a lower MIF.
 6 Q. Let's assume that is true, which I suggest to you that
 7 it is not. But the MIF does lead to increased sales.
 8 Have you in your report satisfied those four conditions
 9 for the first condition of article 101(3)? That is to
 10 say have you categorised the nature of the claimed
 11 efficiency, the link between the MIF and the efficiency,
 12 but more importantly the likelihood and magnitude of the
 13 efficiency? Where in your report have you calculated
 14 the magnitude of this efficiency? That is to say the
 15 level of increased sales that merchants obtained by
 16 reference to the MIF.
 17 A. Yes, I think this is one of those things that probably
 18 economics, or no one can actually quantify or -- so it
 19 is a question one can't answer precisely.
 20 What I have done in detail in section 5 is review
 21 the evidence for the question: do merchants benefit?
 22 Through individual sales I think that is reasonably
 23 obvious, but also in the aggregate. So I looked at all
 24 the evidence and discussed it systematically and
 25 I concluded they do. But can you quantify it? No. It

116

1 is a yes/no answer.
 2 I think the answer is yes, they do benefit, and
 3 therefore I conclude that merchant -- so the credit
 4 facility, some of the costs should be included in the
 5 MIF, but I cannot quantify and therefore, no, I have not
 6 done that in my report. I have identified the nature of
 7 the benefit, but not the magnitude.
 8 MR JUSTICE BARLING: You can't quantify the benefit of
 9 merchants as a whole from increased sales due to the
 10 MIF?
 11 A. Yes, correct. I think it is very difficult for anyone
 12 to quantify the effect of, say, credit card credit as
 13 a whole on aggregate spend.
 14 MR BREALEY: I'm moving on to a different topic. I don't
 15 know whether that would be a convenient moment to pause?
 16 MR JUSTICE BARLING: Yes.
 17 MR BREALEY: I'm making very good progress.
 18 MR JUSTICE BARLING: Good. Are we on target to --
 19 MR BREALEY: Mr Harman on Monday.
 20 MR JUSTICE BARLING: -- finish this witness some time
 21 tomorrow?
 22 MR BREALEY: Yes.
 23 MR JUSTICE BARLING: Mr Brealey, I appreciate the
 24 difficulties in doing this, but are you able to give any
 25 prediction for those who might otherwise be excluded?

117

1 MR BREALEY: I think if the students are coming tomorrow
 2 morning, they will be okay. But then I'm going into,
 3 really, stuff that is confidential to MasterCard.
 4 I have got to sort Maestro out, for example. So that is
 5 pretty historic, but --
 6 MR JUSTICE BARLING: The morning looks as though --
 7 MR BREALEY: I will do my best so they get their hour's
 8 session.
 9 MR JUSTICE BARLING: And also for the benefit of anyone who
 10 is here now who needs to know. All right.
 11 I think there are some questions for the witness.
 12 MR BREALEY: Okay.
 13 MR JUSTICE BARLING: Is it convenient to take them at this
 14 stage? I hope so.
 15 MR BREALEY: Absolutely, yes.
 16 MR SMITH: Mine is not a question for the witness, but
 17 a request for the parties.
 18 Questions by THE TRIBUNAL
 19 PROFESSOR JOHN BEATH: I have a question. It goes back to
 20 this thing about if, in the cost-based method, you
 21 should take account of revenues which you generate from
 22 interest.
 23 I was thinking to myself what would William Baxter
 24 have made of all of this, because if you think back to
 25 the original model, what he is doing is building up

118

1 a demand curve for a transactional service and a supply
 2 curve of transactional services. And there are two
 3 people in that supply process: the acquirers and the
 4 issuers.
 5 When you think about what they are trying to do, at
 6 what price am I willing to supply this much of
 7 a service, now, that generates their cost curve or
 8 supply curve. Why would an issuer, in thinking about
 9 their bit of the aggregate supply curve, why wouldn't
 10 they want to take account of potential revenues as a way
 11 of -- because, you know, it is a willingness to supply,
 12 and revenues seem to be a part of that?
 13 A. Yes, no, absolutely. So -- and also to be clear, back
 14 to basics, the original Baxter model which you referred
 15 to, that was the first one to really set this out
 16 systematically. That does take into account issuer
 17 revenue.
 18 So the Baxter method is clear. The Baxter method
 19 looks at what are the total -- what is the merchant
 20 demand curve? So everything you can get out of
 21 merchant's willingness to pay. And what's the total
 22 issuer -- cardholder demand curve, which includes issuer
 23 revenue.
 24 Then Baxter shows, if you also look at supplies, so
 25 the acquirer cost and the issuer cost, Baxter shows, if

119

1 you are just adding all the curves together, that in
 2 equilibrium Baxter shows that it is only by coincidence
 3 that at that point the merchant willingness to pay
 4 exactly covers the acquirer cost and the issuer revenue
 5 exactly covers -- the cardholder revenue exactly covers
 6 the issuer cost. It is only by coincidence. It is more
 7 likely than not that you get an imbalance in the system,
 8 and that's the MIF. That is the optimal MIF. It
 9 reflects that imbalance, so that does take into account
 10 issuer revenue, to be clear.
 11 The whole story on the cost methodology, it is for
 12 practical reasons that that is a proxy, because you only
 13 then have to measure costs. And there are certain
 14 advantages to it, but those three costs are in a way
 15 an approximation of that original imbalance in the
 16 Baxter method.
 17 PROFESSOR JOHN BEATH: Thank you.
 18 MR JUSTICE BARLING: Just on that -- sorry, I'm sure you
 19 have already answered this and forgive me if you have,
 20 and it is probably in your report. But once on the
 21 Baxter method you have worked out what the imbalance is,
 22 the costs and revenues on both sides of the two-sided
 23 market, the MIF is the attempt to balance it. But it
 24 seems that the way MIFs are arrived at don't use
 25 a mathematical, if you like, or economic approach, but

120

1 they could, could they? They could just look at the,
 2 I don't know, the cost side is -- you have got the,
 3 whatever it was you said, 70% to 80% of the revenue
 4 and 90% of the cost. Presumably there is some economic
 5 model or some algorithm you could use to adjust it?
 6 But that's not a method that appeals to anybody?
 7 A. No, I think that is mainly for practical reasons. So
 8 I think the EDC three heads of cost is an approximation.
 9 But I think also EDC, Mr Sidenius tried to explain that
 10 in 2002, I believe they tried to do that whole exercise
 11 as a cross-check. And what they found I think is, yes,
 12 if you look at everything in the round and
 13 mathematically, what's the difference? What's the
 14 imbalance? Then that was actually reasonably in line
 15 with the three heads of costs.
 16 MR JUSTICE BARLING: So they did it as a cross-check?
 17 A. They did it as a cross-check at the time.
 18 I think another factor here that is relevant, Baxter
 19 also describes how historically these things came about
 20 before any economist had any model, right? So it was
 21 sort of naturally -- maybe this is my market knows best
 22 argument, but these old systems, cheques and credit
 23 cards, the participants in the scheme they kind of knew
 24 what was the imbalance. Baxter merely provided
 25 a justification: look, it shouldn't be --

1 2 1

1 MR JUSTICE BARLING: It is the clearing of cheques in the
 2 early American system?
 3 A. Yes, the market created interchange, if you like.
 4 MR JUSTICE BARLING: Yes.
 5 MR BREALEY: As Professor Beath knows, the Commission
 6 analysed Baxter in the Commission's decision at
 7 paragraph 702 and onwards quite substantially. The OFT
 8 did as well.
 9 MR JUSTICE BARLING: Yes.
 10 MR BREALEY: Remember that Mr Sidenius, on his two
 11 cross-checks, neither study he accepted were
 12 article 101(3) compliant.
 13 MR SMITH: Mine was more a point of information, very
 14 sensible of the considerable help we have had from both
 15 parties to date. But we were wondering whether it would
 16 be possible for MasterCard to provide us with a schedule
 17 of the UK MIFs that it set over time over the claim
 18 period, but to do so not on a blended or average basis,
 19 but to provide us with the MIFs that were applicable on
 20 a card-by-card or card type-by-card type basis for both
 21 debit and credit cards.
 22 MR JUSTICE BARLING: And premium and --
 23 MR SMITH: Indeed. So we would like to be able to see what,
 24 for instance, the MIF was for a premium card as well as
 25 for a standard credit card, as well as for a debit card,

1 2 2

1 and there may be other varieties in between.
 2 I don't know whether MasterCard will have the
 3 equivalent Visa MIF rates. If those are available, we
 4 would obviously be interested in seeing those also.
 5 Then, finally, and this is more for Sainsbury's,
 6 having heard about the pound-for-pound monitoring of
 7 Sainsbury's costs, we wonder whether it would be
 8 possible to have a breakdown of, again, over the claim
 9 period, what Sainsbury's paid to its acquiring banks
 10 both in terms of the rate, in other words, the merchant
 11 service charge rate that was paid as a percentage, or
 12 whatever rate it was, and the total amount in absolute
 13 terms that was paid, ideally differentiating between
 14 card schemes.
 15 MR BREALEY: Okay.
 16 MR JUSTICE BARLING: Good. Thank you.
 17 We will see you tomorrow. Make sure you don't
 18 talk --
 19 MR COOK: Sorry, Mr Smith, one question on that query. You
 20 asked for a rate schedule. Do you want us to break it
 21 down into volume of business? I think that would be
 22 difficult to do. If you wanted a rate table that would
 23 be considerable easier.
 24 MR SMITH: No, I think just a rates table is all we would
 25 like. Thank you.

1 2 3

1 (4.30 pm)
 2 (End of open session)
 3 (The court adjourned until 10.30 am
 4 on Friday, 26th February 2016)
 5
 6
 7
 8
 9
 10
 11
 12
 13
 14
 15
 16
 17
 18
 19
 20
 21
 22
 23
 24
 25

1 2 4

1368 (1) 20:3	3.1.4 (2) 17:19 18:21	<u>6</u>
1390 (2) 93:18 94:12	3.14 (1) 17:20	6 (5) 3:5 10:18,19
1392 (1) 95:6	3.17 (1) 92:8	52:24 99:12
15 (5) 33:17 46:9,17	3.2 (2) 19:14,21	6% (1) 102:8
94:24 104:23	3.27 (1) 92:10	60/70 (1) 102:25
16 (3) 4:9,10 36:23	3.6 (1) 104:7	636 (1) 3:8
16-year (1) 10:9	30 (2) 74:2 92:25	670 (2) 48:11,18
17 (1) 3:21	30-day (1) 71:8	671 (2) 48:11 49:5
19 (3) 53:11 93:19	30p (2) 73:24 74:5	672 (2) 48:11 49:7
94:12	316 (1) 14:2	686 (1) 105:15
194 (1) 46:24	324 (2) 14:2,22	
195 (1) 46:24	326 (1) 10:20	<u>7</u>
196 (2) 46:24 47:13	332 (1) 105:23	7 (3) 38:20 94:15 95:8
1980s (1) 86:13	338 (2) 10:19 11:8	70% (5) 108:23 109:3
1987 (1) 86:6	343 (2) 46:17,23	111:17,18 121:3
	345 (1) 104:24	702 (1) 122:7
<u>2</u>	35.1 (1) 94:17	795 (1) 29:3
2 (10) 30:15 36:20,21	362 (2) 99:15,17	796 (1) 29:10
45:14 54:15 55:11	373 (1) 27:25	799 (1) 29:3
55:24 58:24 125:4	378 (1) 104:1	
125:5	379 (4) 104:1,2,18,20	<u>8</u>
2.00 (1) 45:17	38 (5) 80:7 125:7,8,9	8 (2) 24:1 25:21
20 (4) 17:20 40:22,25	125:10	8.14 (2) 28:6 32:7
41:13	380 (2) 99:19 104:14	8.15 (1) 88:7
20-million (1) 41:15	383 (2) 22:6,7	8.19 (2) 33:13 35:6
2000 (3) 3:25 4:10,19	38A.13 (1) 80:23	8.53 (3) 22:6,7,9
2002 (3) 7:15 85:21	38A.7 (2) 80:8,8	8.55 (1) 24:12
121:10	38A.8 (1) 80:12	80% (5) 108:23 109:3
2004 (3) 94:19,22	3A (1) 2:23	111:17,18 121:3
95:1		81(3) (1) 53:25
2004/2005 (1) 87:10	<u>4</u>	83 (1) 80:22
2005 (8) 4:19 12:8	4 (3) 52:14 54:16 85:1	84 (1) 81:5
88:14 89:14 94:20	4.30 (1) 124:1	85 (1) 81:6
94:22 99:16 100:21	40 (1) 95:3	856 (4) 25:2 38:21
2006 (3) 6:12 93:24	40% (2) 110:10,16	39:3,3
94:11	419 (1) 2:16	862 (1) 39:25
2006/2005 (1) 94:18	420 (2) 25:15,22	87 (2) 82:19,23
2007 (10) 13:11,19	4307 (1) 75:12	
87:5,13 94:13 95:1	436 (2) 53:12,16	<u>9</u>
97:22 99:3 100:14	44 (1) 86:20	9 (2) 36:25 37:7
103:6	447.17 (1) 3:3	9.4 (1) 37:12
2008 (11) 19:25 88:16	459 (1) 30:3	90% (1) 121:4
89:11,15,18 93:10	460 (1) 30:15	92 (1) 99:19
93:15 94:13 96:8	461 (1) 30:16	93 (1) 100:2
99:10 100:21	463 (1) 30:23	938 (1) 14:1
2009 (2) 8:14,20	464 (1) 31:4	95% (3) 109:2,3
2010 (4) 93:7,8,9 99:4		111:18
2012 (1) 18:2	<u>5</u>	98 (1) 4:12
2013 (2) 16:12 97:20	5 (12) 52:23 85:3,5	
2015 (1) 97:19	89:20 101:24 102:1	
2016 (2) 1:1 124:4	111:23,25 112:5,13	
202 (1) 75:12	112:17 116:20	
207 (1) 53:23	5.1 (1) 85:7	
209 (1) 104:25	5.15 (2) 88:7,9	
21 (2) 38:21 95:6	5.16 (1) 88:9	
211 (2) 104:25 106:7	5.18 (1) 88:11	
214 (1) 4:6	5.2 (3) 89:8 91:3,6	
22 (1) 30:2	5.20 (2) 88:18,21	
232 (3) 53:12,16,16	5.3 (1) 85:14	
25% (3) 90:7 91:12	5.36 (2) 113:12,23	
92:1	5.4 (3) 87:17 92:14,15	
25th (1) 1:1	5.82 (1) 88:24	
26 (1) 19:24	5.84 (1) 89:7	
26th (1) 124:4	5.85 (1) 89:7	
27 (1) 39:25	5.89 (3) 89:10 90:1,3	
28 (1) 102:9	50 (3) 75:16 76:3	
287 (1) 85:3	80:13	
28th (1) 16:12	50% (4) 11:21 90:7	
290 (3) 88:7,8,9	91:12 92:2	
293 (1) 113:5	51 (4) 76:5,12 80:13	
2A (1) 79:24	80:15	
	52 (2) 76:13 77:22	
<u>3</u>	53 (1) 77:5	
3 (14) 2:12 17:11 22:8	54 (3) 16:9 75:16	
28:25 29:2 36:19	77:13	
84:23,23 98:24	590 (1) 29:2	
99:2 102:5 113:1,1	5C (1) 113:8	
125:6	5C.2 (1) 113:9	
3.1 (1) 17:15		

