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The ‘magic of zero’ interchange fees

The Court of Appeal backs retailers against card schemes

‘The magic of zero is that … the agreements to impose default interchange fees, are absent’. In this counterfactual, said the English Court of Appeal (CA) credit and debit cards would be ‘settled at par’ and not at the default multilateral interchange fees (MIFs) set by Mastercard and Visa. After several setbacks, the UK high street retailers have not only won but look set to reclaim most of the interchange fees they paid. The victory celebrations may be short-lived if the card schemes appeal to the Supreme Court (as they will).

Background

So far there have been three confused and contradictory judgments handed down by the Competition Appeal Tribunal (CAT) (*Sainsbury's v. MasterCard*) which the retailer won; and two later decisions by the High Court (*Asda (or AAH) v. MasterCard; Sainsbury's v. Visa*) which the retailers lost. The CA heard appeals against these judgments together to hold that MasterCard's and Visa's default MIFs infringed Article 101TFEU. It remitted any Article 101(3) exemption and quantum to the CAT for re-determination.

CAT's bilaterals rejected

The CAT in *Sainsbury's v MasterCard* held that default MIFs were illegal. It rejected the European Commission's counterfactual in *Mastercard* by replacing it with a ‘bilateral counterfactual’ where merchants and acquirers negotiate interchange fees. However, neither party nor any of their experts endorsed this counterfactual. The CA said the Tribunal's bilateral counterfactual was unrealistic and its own ‘construct’ which had no evidential basis; and set it aside.

Popplewell J's ‘death spiral’ rejected

In *Asda v. Mastercard* the High Court (Popplewell J) posited zero MIFs as the counterfactual but found these to be ‘unrealistic’ because it would throw MasterCard into a ‘death spiral’. Popplewell J took the view (as did the CAT) that Visa's MIFs would remain unconstrained in the counterfactual. With MasterCard offering zero interchange fees, there would be no incentive for merchants to agree to any other, and issuers would all migrate to Visa. Popplewell J's ‘asymmetrical counterfactual’ was rejected by the CA (and Philips J in *Sainsbury's v. Visa*) on several grounds. First, it was incorrect in law to consider a ‘death spiral’ under Article 101(1) as that assessment concerned the acquirer market. The ‘death spiral’, if it existed, would take place in the ‘intersystem market’. Further the prospect of commercial failure could not justify anticompetitive behaviour, as this would undermine competition law, and be a charter for the weak and inefficient. Secondly, the CA (and Phillips J) said that Popplewell J (and the CAT) was wrong to hold that a) Visa's interchange fees would be unaffected in the counterfactual; and b) that the claimant had to establish the ‘material identity’ of the MasterCard and Visa card schemes. It was unrealistic and improbable that Visa's interchange fees would be left at their illegal levels in the counterfactual. Both MIFs would be zero. Further, the claimants did not have to establish the ‘material identity’ of the MasterCard and Visa schemes as this was obvious.

The CA's counterfactual

The CA [124] went full circle to endorse the European Commission's and CJEU's counterfactual:

> … the CJEU's [MasterCard] decision, which did not depend on a determination of fact by the Commission that, in the absence of MIFs, there would be a “highly competitive process” between issuing and acquiring banks in the form of bilateral negotiations which amounted to “actual competition”. The CJEU's decision at [195] expressly referred to the effect of the MIF being to limit the commercial pressure which merchants were able to exert on acquiring banks. That was a restriction of the competitive process on the acquiring market. The restriction in question was the impediment to the merchants' ability to drive down prices charged by acquirers, due to the setting of the price floor, not the absence of bilateral negotiations. Since that impediment does not arise in a payment card scheme providing for settlement at par, in which competitive forces can operate unfettered, a positive default MIF is necessarily restrictive compared to a zero MIF counterfactual. [*emphasis added*]

The CA [125] concluded: ‘In the words of the General Court at [143], such harm “necessarily” follows where a positive MIF is compared with a zero MIF’.

Unfortunately this counterfactual fails to set out how the competitive process would operate to set interchange fees. The economics of two-sided markets summarised by Phillips J [47]-[60] show that unrestrained MIFs can

be excessive, and the pressures exerted by merchants weak. The implication is that counterfactual with zero MIFs is a counterfactual without interchange fees. And, a counterfactual with interchange fees set at any level would stay at the level unless under some 'artificial concept of "competition"' (Phillips J [161]). Since the CA comprehensively rejected bilateral negotiations, it is hard to see how competitive pressures in the acquirer market would manifest themselves in the CA's counterfactual world.

But Article 101 has a complex sequential structure where restrictions can be exempted if they are a) 'objectively necessary'; and/or b) generate and share efficiencies with consumers under Article 101(3). The CA closed off these avenues for the card companies – the default MIF was not an ancillary restraint because card schemes operated without interchange fees; and the grounds for exemption under Art 101(3) had not been proved.

Article 101(3) exemption

The CA said that Popplewell J was wrong to exempt MasterCard under Article 101(3). It rejected the proposition that card schemes were 'output-expanding' and therefore inherently pro-competitive. Card expansion could not be assumed to be positively correlated with economic benefits in a mature card market. The higher sales attributable to one card scheme was just as likely come from another card scheme with no overall net increase in sales. Secondly, neither MasterCard nor Popplewell J had established a causative link between the MIFs and the benefits to merchants and card users. It was just assumed that an interchange fee benefited both rather than being pocketed by the card issuers, and moreover it ignored that interchange fees were a very small proportion of the total revenue generated by card schemes. Putting all this aside the failure to establish grounds for exemption were not points of principle or economics but evidence – neither MasterCard or Visa provided evidence (although the CA criticised Phillips J handling of the evidence of card user benefits which has been remitted to the CAT).

Damages

The CA [352] held that:

> '…the merchants do not bear the burden of proving the lawful level of MIF. The correct analysis is to apply articles 101(1) and (3) in order to determine whether or not the default MIF, as charged, is in whole or in part unlawful, and then to assess damages on the unlawful amount or level as so determined.

As the law now stands the counterfactual default MIF is zero with the defendant required to prove a positive 'exemptible' MIF. This is good for claimants who often struggle to establish quantum. But how is the exemptible MIF to be calculated? and How does it relate to the counterfactual? Two methods have been used so far – the cost-based approach adopted by the CAT, the Commission's Visa undertaking and the card schemes and; the Merchant Indifference Test (MIT) used by the European Commission, Popplewell J, regulators and economists to determine the socially optimal interchange fee, but not used in practice other than by regulators. Strangely, because Sainsbury's accepted and calculated an exemptible MIF in *Sainsbury's v. MasterCard* this stands.

Conclusions

The English Courts have gone full circle to reinstate European Commission's *Mastercard* decision. They have and continue to offer a confused application of the law to card schemes. The main considerations that can be drawn from the cases so far are that:

- Counterfactuals have proved an empty concept which have confused the courts.
- The CA's judgment does not set out a coherent theory of competition.
- Despite the illegality of MIFs, the multi-sided nature of card schemes can be addressed under Article 101(3).
- Evidential issues which proved fatal at first instance were treated as trivial by the CA (e.g. the 'material identity' of the schemes); while others waved through by at first instance were fatal in the CA (e.g. Article 101(3) exemption).
- The card schemes have the burden of calculating any 'exemptible' MIFs.
- The MIT method of calculating an exemptible MIF is a regulatory calculation of the optimal interchange fee that maximises total welfare, which is not the competition law standard, has never been used in practice by the card industry and which recent estimates suggest may be zero or negative.

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