Sainsbury's Supermarkets Ltd v. (1) MasterCard Inc, (2) MasterCard International Inc, (3) MasterCard Europe S.P.R.L.

Day 16 Redacted

February 25, 2016

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Thursday, 25th February 2016
(10.30 am)
(Open session)
MR JUSTICE BARLING: Morning.
MR HOSKINS: Straight to Dr Niels unless there is anything you want to --
MR JUSTICE BARLING: The only thing is just to let you know that there are people -- I am sure everyone is aware -- who want to listen to the proceedings and there is a particular group of students tomorrow morning coming from a university to listen.
Now, I appreciate it is very difficult to give precise indications of when we are likely to be in -- this is really probably more for Mr Brealey, really --
MR BREALEY: It applies to me, really.
MR JUSTICE BARLING: -- in camera, but insofar as you are able to give any indications in advance at any time, that would be helpful. Any pre-indications to the court at large, but also if it were possible by say the close of play to give us an idea of how you see tomorrow morning panning out, simply because we have a group.
MR BREALEY: Yes, sure, I understand.
MR JUSTICE BARLING: So we are obviously in open court as things stand.
MR BREALEY: Yes. So they are due tomorrow morning?

MR JUSTICE BARLING: I think they are due tomorrow morning.
MR BREALEY: For just an hour?
MR JUSTICE BARLING: I'm not sure. I don't know, Ms Boyle, do you know how long? About an hour at the beginning of the morning. Probably after an hour I imagine the eyes will glaze over.
MR HOSKINS: Can I call Dr Niels, please.
DR GUNNAR NIELS (affirmed)
Examination-in-chief by MR HOSKINS
MR JUSTICE BARLING: Thank you, Dr Niels. Make yourself comfortable.
MR HOSKINS: You need D3, please. If you go to tab 3, there should be a document entitled "Expert report of Dr Gunnar Niels"; is that correct?
A. Yes.
Q. If you go through to page 419.
A. Yes.
Q. Is there a signature there?
A. Yes.
Q. Can you confirm it is your signature?
A. Yes.
Q. Then still in this bundle, if you go to the next tab, 3A.
A. Yes.
Q. It should be the "First supplemental report of Dr Gunnar Niels"?
A. Yes.
Q. And at page 447.17, is that your signature?
A. Yes.
Q. Then D3.1 at tab 6, you see "Second supplemental report of Dr Gunnar Niels"?
A. Yes.
Q. The signature should be at 636.
A. Yes.
Q. Can you confirm that's your signature?
A. Yes.
Q. Can you confirm that contained in these three reports, they set out your independent professional opinion?
A. Yes.
MR HOSKINS: Mr Brealey has some questions for you.
Cross-examination by MR BREALEY
MR BREALEY: You can put D3.1 away for the moment. Let's just concentrate on your first report in D3.
I know you have been at Oxera for a long time. How long precisely?
A. Nearly 17 years.
Q. Was MasterCard an existing client of Oxera's or did you bring MasterCard with you?
A. No, we started -- Oxera started work for MasterCard in May 2000, and actually it was the UK member banks of

MasterCard who were united back then in MEPAC and later they became MMF. But they became a client when -- after I had started at Oxera.
Q. So you say -- I'm looking at paragraph 1.5 of your report -- that you advised the MasterCard UK members. It is at page 214. You advised MasterCard UK members during the OFT investigation, correct?
A. Yes.
Q. And that began some 16 years ago?
A. Indeed. 16 years ago. In March 2000 this was the very first notification of the OFT under the new Competition Act 98.
Q. So MasterCard at this time was a new client to Oxera and you had basically just started, I think?
A. Yes, I had started nine months earlier.
Q. What was the advice that you gave? What was the sort of advice that you gave to the UK members of the MasterCard scheme during this time?
A. Yes, so this was from 2000 to 2005, basically the OFT investigation, and thereafter, after the OFT decision, came the CAT appeal. So we were here in this place.
The kind of analysis that we did was actually very similar to the current case; the same issues that we looked at are relevant to the current case. So article 101(1), 101(3), the economic analysis, applying

economic principles to the case on the interchange fee on article 101(1) and 101(3).
Q. I know that you have been in court a lot and you are quite close to the case, but we have seen economic reports during this time from DotEcon, Edgar Dunn, Professor Weizäcker. What reports did Oxera submit?
A. Maybe it is also worth clarifying. We advised MEPAC, so the UK member banks, alongside us in the OFT proceedings but actually separately officially was MasterCard. So I advised the UK member banks.
So the submissions for DotEcon, and Mr Koboldt was here earlier giving factual evidence, he advised MasterCard at the time. We were the economic advisers to the UK members.
I think in this long process there were a few submissions from Oxera on merchant surveys and cardholder surveys. There were a few submissions on the theory of interchange. One of my colleagues, Dr Helen Jenkins, I think presented a few times at oral hearings etc. That's about it in terms of Oxera reports or Oxera named reports in the OFT stage.
Then Dr Jenkins, my colleague, was the expert named -- or the expert for the UK members in the CAT proceedings.
Q. Just again to recap, what was your role in all this?

A. Well, I was in all that time --
Q. You were quite young probably, but what was your role in all this?
A. As a youngster, I was pretty much working with Dr Helen Jenkins. I was, if you like, second in command.
Q. You would review the submissions by the other MasterCard companies, MasterCard Inc, to ensure consistency, I guess?
A. There were certainly working groups together and we would review each other's submissions. I think I have seen most of the work by MasterCard's economic advisers.
Q. Then in 2006, as we know, the OFT opened a new investigation. You were a little bit older then. You say you were involved in it. What was the extent of your involvement?
A. Well, I can't -- it was certainly a lot less, and I can't remember whether it was actually very active because the OFT I think, at that stage, took a bit of a back step and the European Commission case became the leading case.
I think the UK member banks, so our clients at the time, were not that active in the European Commission state. So, certainly, our involvement dropped a little.
Q. So you say it dropped a little, but you do say at one point, by 1.6, that you worked intermittently throughout

the EU investigation. What was your involvement in the EU investigation?
A. Yes, so I think Oxera advised the Royal Bank of Scotland as one of the intervening parties when the -- during the appeal by MasterCard to the European Courts, to the court of first instance at the time. There was a -- at that time, Oxera performed a study on incremental spend and that was put in as evidence I think on behalf of RBS, if I recall correctly, as an intervening party.
Q. That's the one that the Commission rejects in the annex to the decision.
A. Yes.
Q. We will come on to the appeals in a minute.
As far as the EU investigation was concerned, let's start with a Visa exemption in 2002. Were you involved in that at all, reviewing that?
A. We were not involved, I think, as MasterCard, but certainly it came out during that period, so it was a relevant decision to look at at the time.
Q. But MasterCard, did they get involved in the Visa proceedings?
A. I don't know.
Q. Did you liaise with Professor Weizäcker again, and Mr Koboldt and Mr Sidenius at the time?
A. Yes, all of them were involved at the time and we had

various interactions with all of them.
Q. What was the nature of these interactions?
A. I think because we were economic advisers to the UK members and Mastercard International and there were sort of working groups, if you like, so there were also interactions between the economists, lots of interesting brain storms I remember.
Q. What, relating to the MIT-MIF and the issuer's cost methodology?
A. Certainly related to interchange and the theory, also the EDC methodology. I think MIT-MIF, none of us had heard of MIT-MIF back then.
Q. After the infringement decision, did you get involved with the undertakings, the 2009 undertakings that MasterCard gave?
A. No, I didn't and I think Oxera did not at that stage, because at that stage it was pretty much a MasterCard issue and the UK member banks were very much in the background, not so involved, I think.
Q. So after the 2009 undertakings there were the appeals, and I think if we go to paragraph 115 of the report, where you say "The documents that you have reviewed", it is the normal stuff: The legal pleadings, the witness statements. Out of interest, why do you review the witness statements as an expert?

A. I think that's in general terms common practice, and actually good practice because it means as an expert you are -- you can make sure that your economic analysis is rooted in the facts of the case.
Q. Then you have looked at the internal documents relating to interchange fees, and then six bullet points down you have looked at the relevant decisions. Why have you looked at the relevant decisions, the Commission decision in particular? Why are you looking at that?
A. I think, again, that is important context for my economic analysis of this case.
Q. Then the court judgments. Why are you reviewing the court judgments?
A. I think for the same reason.
Q. You say in the last bit of that bullet point that you have looked at the number of submissions leading up to the judgments.
Now, as you probably know, we haven't seen these. Did you take part in these submissions? Did you kind of review them?
A. I did not take part in them. Whether I reviewed them sort of as part of this case, I can't actually recall the detail what I reviewed, what I referred to here. I think certainly one of the things I referred to is the Oxera study on the incremental spend, which went into --

well, the General Court proceeding.
Q. Were you acting for MasterCard in these appeals or any interested issuing bank, or no one?
A. So we did act for Royal Bank of Scotland.
Q. You did, yes.
A. In the court of first instance. But I can't recall whether that was still the case for the ECJ or whether it was still relevant at that point.
Q. If you look over this history, this 16-year history, it is quite clear that you have fought quite a lot of battles with MasterCard.
A. That's one way of describing it. I think I have to say I find the economics of interchange fees fascinating. I have always found it fascinating. In a way I'm pleased that the issues we looked at back then are relevant issues in the current case as well.
Q. Let's go to a few documents, if we can.
Can we go first to E2, tab 6. I want to go to page 338, paragraph 102. Before we do that, tab 6, just to identify the document -- it is page 326 -- this is an appeal against Mastercard International Incorporated Europe.
Now, you were acting for the UK members, as I understand it?
A. Yes.

Q. Did they put a separate appeal in?
A. I can't remember, but I should think so, yes.
Q. They are certainly referred to in the decision. This is the sort of document I think that you have just said you would have reviewed to ensure consistency, correct?
A. This is the sort of document I would have reviewed to inform myself, yes.
Q. So if you go, please, to page 338, paragraph 102, and read paragraph 102 and footnote 103.
A. Yes.
Q. You are a very quick reader.
It says, 102:
"For these reasons the OFT is not entitled to simply conclude that higher interchange fees lead to increase in retail prices. Such a significant conclusion requires evidence. The OFT does not produce any. In fact, it is evident that higher interchange fees might just as well lead to lower or unchanged retail prices."
Then footnote:
"For example, there is no evidence that the almost 50% reduction in credit card interchange fees in Australia that resulted from the Reserve Bank of Australia's regulatory intervention has any impact on retail prices."
Was this something that you shared? This is a view

that you shared at the time?
A. I can't recall whether at the time we really got involved into this question on pass-on, but I think my views -- my views on pass-on are clear. I mean, I have set them out for the purposes of the current case.
Q. Obviously we will come to these, but I'm trying to work out with you whether you shared the view of MasterCard back in 2005 about the experience in Australia, for example.
A. I think what I can say about this is that I would share the view up to the point where it says there is no evidence. And, indeed, looking at it more closely there is no good evidence. And therefore I have not relied on the Australia evidence on pass-on and instead formed my own views.
Q. But this footnote does not suggest a strong economic presumption, does it?
A. This footnote, it is -- it says what it says. It doesn't suggest that there is high pass-on.
Q. It is what it is, but it does refer to the evidence and the Tribunal has to look at the evidence. And this is not just an allegation, this is someone having a look at the experience of Australia and saying there is no evidence.
Anyway, you have accepted that this evidence is not

wholly consistent with a strong economic presumption of pass-on?
A. I accept that this statement is not consistent with a strong presumption on pass-on. I think this statement says more that there is no evidence, rather than that there is evidence one way or the other.
Q. Can you put that bundle away, please, and go to bundle E2.1. This is at tab 10. Just to identify the document, this is a letter from Jones Day enclosing the MasterCard's response to the European Commission's letter of facts. This is March 2007.
Were you involved in this submission at all?
A. No.
Q. Did you review it?
A. No.
Q. Did Oxera play any part in it?
A. No, I don't think so.
Q. So what was the role of yourself and Oxera at this time then, 2007, just before the infringement decision was adopted?
A. I think we actually had no particular active role at that stage, if I recall correctly, because this was very much, at that stage, MasterCard dealing with the case rather than the UK members, and MasterCard had its own economic advisers.

Q. Let's go, if we can, with that proviso, to page 938. If you want to read paragraph 316 to 324. I will just ask you a few questions about this.
A. Yes.
Q. Have you seen this document before?
A. I can't recall that I have. I think not, actually.
Q. This was not shown to you when you produced your report?
A. It probably was in the overall material available to me, but I can't now recall if I looked at this specific submission.
Q. You can't remember whether you saw this document when you were intermittently involved in the EU investigation?
A. I think I'm pretty certain that I did not see this document back then.
Q. If you go to --
A. But I can read this.
Q. Yes, of course. (Pause)
You mentioned a moment ago that you weren't interested in Australia because there was no evidence of pass-on. I think you said it was evidence of absence. But if you see at paragraph 324, the third bullet point:
"A review of the annual reports of some of Australia's largest retailers suggests there is no direct correlation between changes in retailers' cost

base and consumer prices. But rather, retailers tend to absorb small cost changes regardless of the direction of the cost of change."
Just pausing there. I would suggest that is a degree of positive evidence as to what is happening, correct?
A. I think it is an assertion in here. And reading this, I would agree -- I would not agree with this assertion and it is not in line with my analysis of what has happened in the UK.
Q. Then the following table contains data extracted from Woolworths and Coles.
Then, if you go over the page, this is the evidence:
"It shows clearly that there is no correlation between cost reductions, reduced merchant fees and retail prices. Indeed, retailers often take cost changes to ...(Reading to the words)... that influence their prices."
So that is something that you disagree with, or what? This is MasterCard putting forward a positive case based on evidence at the time.
A. I would say this is not conclusive evidence on pass-on one way or the other. The conclusions that are drawn from it in this document, I would therefore not agree with. I have tried to look at more detailed evidence in

the specific UK Sainsbury's context and draw different conclusions.
Q. But would you agree at least that this positive case here is inconsistent with a strong economic presumption of pass-on?
A. This -- the argument made here is inconsistent with that, yes.
Q. If you can put that bundle away, please, and go to E5.4, tab 54. This is something that we have referred to in the evidence in these proceedings. This is the report by Europe Economics, "The economic impact of interchange fee regulation in the UK, 28th June 2013".
A. Yes.
Q. Have you seen this document?
A. I hadn't seen it before the current proceedings.
Q. But did you see it before you drafted your first report?
A. I think yes.
Q. Because this, as I understand it, is on the website, on that website.
A. It may be, yes.
Q. So we know that you saw this before you drafted your first report.
If we go to page 1341, the executive summary:
"Headline findings and impacts for the UK if interchange fee regulation is introduced.

"In Spain and Australia the regulation of interchange fees (IFs) resulted in a transfer of cost from retailer to consumers. Retailers' costs fell as they paid merchant service charges. But this ...(Reading to the words)... the form of lower retail prices."

Then the basis for this, as we have seen there, is two examples, one in Spain and one in Australia, correct?

A. Yes.

Q. So if we go to section 3 of this report, the one which starts at 1357, this chapter is entitled "Past experiences regulating interchange fees".

A. Yes.

Q. Section 3.1 relates to Spain.

A. Yes.

Q. 1357. The authors of this document, they go through the caps, the impact on card payments in the banking sector. And then at section 3.1.4, at page 1360, it looks at impact on consumers. Page 1360, page 20, section 3.14, "Impact on consumers".

So:

"The intended effect of imposing a cap on interchange fees is that they would translate into lower prices of goods and services."

If we go on:

"As reported in Iranzo et al 2012 ..."

Can you just tell me, is that a firm of economists, Iranzo et al?

A. I think they are three economists or academics. I think I looked also at the Iranzo et al study to see where does Europe Economics infer its conclusions from? My own assessment of these studies, so both Europe Economics and Iranzo et al, is that there is actually no good basis for them to conclude, based on the evidence that they have looked at, that there is no pass-on. The evidence is inconclusive either way, and that is why I decided not to rely on it.

Q. Let's just get this straight. You say you saw this just before you drafted your first report, yes?

A. Yes.

Q. You actually looked at this report and then you actually went to the Iranzo study and decided that it wasn't good enough; is that right?

A. Yes.

Q. So when it says in section 3.1.4:

"As reported in Iranzo, this chain of effects did not take place in Spain. Although the reduction did result in lower MSCs, no evidence of it having been passed through to a degree ...(Reading to the words)... was found by the study. The authors found no evidence of an improvement ..."

So you have studied this and come to the conclusion that you don't agree with it. That's essentially your evidence to the Tribunal?

A. Yes, indeed. Because the general theme in this study and the Iranzo study, and also in Australia, is there is no evidence of pass-on, and MasterCard then made a lot of that.

Indeed, the principle I put forward is the fact that you find no evidence of pass-on doesn't mean that there isn't pass-on. So the absence of evidence isn't evidence of absence.

Q. Then we go to Australia. 1362, section 3.2, "Impacts of regulating interchange fees in Australia".

Then the footnote. This is at page 1362. I don't know if you have it?

A. Yes.

Q. This is after there is no evidence that retail prices were reduced in Spain.

We get to Australia, 3.2:

"Impacts of regulating interchange fees in Australia. The summary presented," this is at footnote 26, "next is drawn from CRA International 2008."

Did you go and have a look at that report?

A. Yes.

Q. You will see over at 1368 at the top, "effect on prices". This is what CRA -- CRA are a fairly respected firm of economists, aren't they?

A. Yes.

Q. They are your competitors?

A. Yes, they are.

Q. So again, they say:

"RBA [this is the second paragraph] expected the decrease in IFs to be passed through to consumers as lower prices thanks to vigorous competition at the retail level."

Now, is that something that you disagree with there, that there was vigorous competition at the retail level? Did you analyse that?

A. I haven't analysed the Australian retail market, whether there was vigorous competition.

Q. Just pausing there. So if you take that at face value, isn't that inconsistent with a strong economic presumption of pass-on in the present case where you rely on vigorous competition?

A. Yes, the RBA statement here, or the expectations by the RBA that a decrease in interchange fee would be passed on to consumers because of vigorous competition, that is

in line with my economic presumption of high pass-on. I think then the debate in these studies here is about, well, is there actually evidence for it.
Q. "As in the Spanish case, no evidence was found, neither for a reduction in retail prices nor of an improvement in the quality of product. CRA also explain this as a consequence of the very small reduction in the price per transaction if passed through from MSCs to prices would have taken place."
So CRA here are saying there's no evidence of pass-on even though there's vigorous competition, and it may well be due to the small nature of the MSC. Is that something that you disagree with?
A. Yes, so there is two points being made here. One, again, the theme of there is no evidence on pass-on and it is my absence of evidence point. To be fair to perhaps CRA, it is very hard to observe pass-on, especially with public data. I mean, it is hard enough in the current case, as we will no doubt come to, but in the current case at least we have much more detailed evidence from the retailers themselves.
I think the way CRA and also Europe Economics looked at it was much more at the aggregate level, and there you cannot -- it is very difficult to observe either way whether there is pass-on or not.

The second point that CRA make here about it being a small cost item and therefore it won't have been passed on, I disagree with.
Q. You can put that bundle away and go back to your first report please. This is D3. I would like to go to page 383, I think, paragraph 8.53. I'm looking at paragraph 8.53, page 383 of your first report at D3, tab 3.
At 8.53, you say:
"There is a large body of literature assessing the extent to which different types of cost change are translated into changes in final prices. In this section I present an overview of this literature to complement the insights presented in the previous sections. I have not been able to identify specific studies that provide a robust empirical assessment of the extent to which merchants passed changes in the interchange fee/MSC onto their customers. In this section, I therefore focus on empirical pass-on studies for other cost items such as VAT and wholesale prices."
Now, why did you say that you have not been able to identify specific studies? Is it simply because you did not regard the studies as robust enough?
A. Yes. I think that sentence very much refers to that.
So there were the Europe Economics and NERA and CRA

and Iranzo studies. But, yes, indeed, the reason why I say I have not been able to identify specific studies that provide a robust empirical assessment of the extent of pass-on is that. I accept that I should probably have footnoted the fact that I refer here to the studies that I did see.
Q. So you do accept that. Why do you on reflection now accept that you should have footnoted a reference to the studies that you have seen?
A. Just to clarify my statement here that -- which is a correct statement -- I have not been able to identify studies which provide a robust empirical assessment of pass-on.
Q. But when you drafted this report, Dr Niels, this evidence was supposed to be given in the High Court. You know that, don't you?
A. Yes.
Q. And it is now being given to the Tribunal. Do you not believe that it was your duty to refer the court or the Tribunal in your first report to these studies and then set out the analysis that you say was flawed? Do you not consider that you should have been upfront about these studies?
A. I think I should have been -- I think I should -- yes, I think I should have been clearer about those studies.

To put my section 8 in context, there is a lot of bits of evidence that I looked at in pass-on to build the overall picture of what I call the economic presumptions. So I looked at a lot of studies and a lot of empirical studies, and I didn't comment on everything in here. But I accept, having seen now also how all the evidence has been presented in the hearings, that it would have been helpful if I had specifically mentioned the reasons why I didn't think that the studies that we just went to were sufficiently robust to be worth mentioning.
Q. If you go on, here at 8.55 you say:
"I have reviewed a number of academic papers that estimate the rate of pass-on, provide an overview of the estimate obtained in those papers in appendix A1. I have selected only papers that assess pass-on in retail markets that are sufficiently comparable to the market Sainsbury's operates in."
Do you not consider that the retail markets in Spain and Australia were at least sufficiently comparable to the market Sainsbury's operates in?
A. Here I made the selection of academic papers. So that is already another selection criteria that I applied. So the other studies in Australia and Spain were not academic papers, or not -- certainly not published

academic papers.
Q. Then, in 856:
"I provide a summary of these studies. Some of them relate to retail markets in the UK. I have also included findings from other countries."
So you are obviously not adverse to taking some analogy from other countries, are you?
A. No, because some of these academic studies, like the ones for the US, have done a detailed study on pass-on, for example in certain products in the US, like cars and some agricultural products. And for the reasons that I have set out here, I consider that relevant information or relevant analysis for what I call my economic presumption of pass-on.
Q. If we go to page 420, this is the information in appendix A1 that you are putting forward to the High Court and now to the Tribunal as to why there is strong economic pass-on. So:
"This summarises the results of my review of the empirical academic literature pass-on as discussed in section 8."
You go down this, this is at page 420. So this is what you are putting forward to the Tribunal as evidence that you are relying on. And you look at it, and:
"Origin of pass-on, wholesale US gasoline, tax,

wholesale prices, tax on alcohol, tax on gasoline, tax on cigarettes, tax on alcohol" again.
I suggest to you, Dr Niels, that a study of pass-on of interchange fees by retailers in Australia and Spain is going to be of greater assistance to the Tribunal than some regression analysis of gasoline tax in America. Do you not accept that?
A. No, I disagree because these are all academic studies. So there is a certain element of rigour to it. That was the criterion that I applied in this bit of my evidence, so the existing academic literature on pass-on.
I did try to select, as I said earlier, markets that are reasonably closely related to retail markets. Of course I accept these are different markets and also different nature of cost changes to those markets, but nonetheless, for my overall picture or at least my own analysis of what do I conclude on pass-on, I find this to be relevant literature.
The previous studies that we talked about, they are not -- they don't deserve to be in here from the -- applying the criterion of robustness.
Q. Let's just get it straight, can we? You say that the studies that you have relied on, which relate to, for example, tax on US gasoline, that study is more relevant than the study on whether or not interchange fees have

been passed on by retailers in Spain and Australia?
A. Yes, that is my view. So these studies inform my analysis on pass-on because they show how does pass-on in these types of markets work? What sort of pass-on rates do you observe.
Of course this is not my only or even my main evidence. I then look also at Sainsbury's specific pass-on behaviour and evidence on also these types of costs so it is not overly dissimilar. But that leads me then ultimately to my conclusion about high pass-on.
So this literature is informative. If there had been an academic study on pass-on of interchange fees or merchant costs, merchant service charges, then of course that would have been relevant. But my criterion, as we discussed earlier, was that there aren't any robust empirical academic studies on this.
MR BREALEY: Just whenever you want to break? I can go for another 10 minutes --
MR JUSTICE BARLING: You think this is a natural point, do you?
MR BREALEY: I'm going on to another paragraph, but I can go for another 10 minutes.
MR JUSTICE BARLING: We will go a bit longer, thanks.
MR BREALEY: We were in appendix A1. Could we go back in your report to page 373. This is where, in these pages

here, you cite various passages by, for example, the European Commission and the retailers all giving the impression, or giving, you say, support for your strong economic pass-on, correct?
A. Yes.
Q. So at 8.14, you say:
"Examples of the Commission's conclusions and reasoning can be seen in the following statements."
Then you set out some of the statements, yes?
A. Yes.
Q. All with a view to supporting the strong economic pass-on. But you personally, as an expert economist, I think agree that pass-on has to be considered on a case-by-case basis, correct?
A. Yes.
Q. I think you also know, you also accept, that the EU Commission believes that pass-on must be considered on a case-by-case basis, correct?
A. I don't know if the Commission believes that in an official manner, but it is -- I think it is accepted wisdom that you need to assess pass-on on a case-by-case basis.
Q. Just to put some context to that, you will need D3 open, but could you go to bundle D2.1, which is Mr von Hinten-Reed's second report, at tab 3.

A. Sorry, which number?
Q. It is bundle D2.1, tab 3, and it is page 590. We won't go through it all, but it is paragraph 795 to 799.
As I understand it, you are both agreed that pass-on should be assessed on a case-by-case basis? That's what you have just accepted.
A. Yes.
Q. And here are some of the passages that he has cited as authority for that. One of them is your book, but one of them is 796:
"This view is supported by the Commission in its practical guide."
And it says:
"It is not possible to establish a typical pass-on rate that would apply in most situations. Rather, careful examination of all the characteristics of the market in question will be necessary to assess pass-on rates.
"In a specific case, the existence and degree of pass-on is determined by the range of different criteria and can therefore only be assessed having regard for the conditions of the market in question."
So you would accept what the Commission is saying?
A. Yes, I agree with that.
Q. So if you can put him away for the moment and just pick

up bundle E1. At the end, almost at the end there is a tab 22 which is actually a European Commission document, it starts at page 459, dealing with the interchange fee regulations. So dealing with the very thing that we are talking about in these proceedings.
Have you seen this document before?
A. I can't actually recall this document.
Q. There are quite a lot, but let's have a look at it then.
A. Yes.
Q. Have you read Mr Harman's report?
A. Yes.
Q. Well, it was exhibit 103 to his report. This is where I got it from: Exhibit 103 to Mr Harman's report. This is a policy brief. We will just flag the pages.
So page 460, internal page 2, gives a summary of the problem with interchange fees. Page 461 explains the business stealing effect:
"Merchants and consumers are problematic. They didn't have sufficient counterweight to match the power of card schemes."
It goes on.
Then the next page deals with the solution. Page 463 deals with why the regulation is necessary. It is the last page I just want to draw your attention to:
"What are the benefits of the interchange fees

regulation?
"Creating a level playing field for interchange fees will facilitate market entry of new players."
This is at 464:
"It will offer better prices to merchants with benefits for both retailers and consumers. Lower interchange fees will ...(Reading to the words)... retailers will pay less and so will be encouraged to accept card payments. They will also have more possibilities and be in a better position to choose an acquiring bank.
"Consumers overall will benefit. Consumers using low cost means of payment, such as cash or debit cards, will no longer subsidise the use of ...(Reading to the words)... compete on their own merits."
This is the point I want to just refer you to:
"Due to the higher competitive pressure in retailing than in retail banking, it is likely that cost savings to merchants will be passed on to consumers through lower retail prices more than the benefits of high interchange fees were passed on by banks to their customers. However, many factors influence retail prices. The pass-through would depend on the retail sector considered, the size of the merchant, its use of payment instruments and the basket of purchases/basket

of goods and services being bought by the consumer."
Again, I suggest to you that is a clear steer from the Commission that you have got to look at this on a case-by-case basis.
A. Yes, I agree.
Q. If you put E1 away. I hope you would accept -- so from 8.14 where you cite the Commission's statements -- that this gives the impression that pass-on is almost inevitable, whereas you have just accepted with me in your evidence to the Tribunal that it is not inevitable, you have got to look at it on a case-by-case basis, correct?
A. You have to look at it on a case-by-case basis. The weight I gave to all these statements by the authorities is that -- actually, what I say is in line with my economic understanding of pass-on: that you would, in markets like these, expect high pass-on. But also the other factor that I'm giving weight here is that it has -- it is very much at the heart of the theory of harm by the authorities, both by the OFT and the European Commission, that interchange fees by loading costs to merchants lead to too many credit cards in society and the economy, and that's a market failure. So competition not leading to the right outcomes.
That's very much at the heart of the concern, and

the pass-on comments are in line with that. Because we saw that earlier in the documents, the comment about cross subsidy. That is precisely the pass-on comment.

So retailers face these higher cost payment systems and then all consumers pay for it because these high costs are passed on by the retailers to prices.

That's the context in which I read these statements. The OFT called it the tax on consumers, so that's another statement in line with this. To me, that is helpful context, but still I agree with the proposition that one then has to also try to look at the evidence in each specific case.

Q. If we go to paragraph 8.19, this is after you have referred to the Commission's statements.

You say:

"Statements made by retailers and by the retail associations, such as BRC, over the last 15 years paint a similar picture of high pass-on. Again, these are not empirical evidence as such, and I'm aware that card schemes have at times sought to challenge these statements."

So:

"... I am aware that card schemes have at times sought to challenge these statements."

Just pausing there, you set out in this report,

which, as you know, is supposed to be independent, impartial and of assistance to a court or tribunal -- having set out what the Commission is saying, you don't set out what the card schemes have said and which we only got to know about because of the specific disclosure application. Why did you not set out the statements by Mr Perez and Mr Douglas? Don't you think this gives a slightly imbalanced view on it when your own client has been disagreeing with these statements?

A. Yes, I think I have been clear in -- where I present the statements that there are statements from these three sources and I don't consider them to be evidence, but I consider them to be helpful background. I have also made clear that I do put a bit more weight on the statements by the authorities because that was very much at the heart of their theory of harm, as I explained. Also I have explained why I would put a bit more weight on the statements by retailers, because at the end of the day retailers are probably in a better position than the card schemes to judge how they -- or to give an indication how they see pass-on by themselves.

And part of my consideration here was also that, yes, I was aware of MasterCard's statements to the contrary, but yes, quite frankly, I thought -- and we saw the evidence that that wasn't very strong --

I thought they weren't very supported statements.

But by no means -- I knew those statements were all in evidence, so by no means I'm trying to create the impression that there are only statements one way.

Q. So you have just said, and I think this is consistent with what you said in 8.19, that retailers are in a better position than the card schemes to give a view on pass-on, but you are aware that the card schemes have been -- they have instructed economists to help them. It is not just the view of the card schemes themselves. I mean, card schemes have instructed and relied on firms of economists.

Why is it that retailers are in a better position than card schemes when they rely on views of their economic advisers?

A. I think the studies we just looked at, Europe Economics, CRA, they did not have good access to data and therefore could not perform a proper analysis of pass-on. I'm in a different position because of this case, there is much more information from the retailers themselves.

So I think I have now been able to do more analysis of pass-on than the previous sets of economists have.

Q. But why is it that retailers are in a better position?

A. That's, I think, just a general proposition that retailers -- or the information on how retailers set

prices exists within the retailers. And, indeed, in this case everyone looked at a lot of evidence from Sainsbury's to infer conclusions on pass-on.

Q. So if retailers are in a better position than card schemes, would you accept that Mr Coupe and Mr Rogers are in a better position than yourself?

A. They are in a good position to comment on from their business perspective. What I have done is to look at the economic analysis and the evidence in the round, and I have drawn my conclusions on pass-on from that.

MR BREALEY: It is probably a good moment.

MR JUSTICE BARLING: All right, we will have a short break.

Dr Niels, you know the form, don't you, about not talking about --

A. Yes.

(11.40 am)

(A short break)

(11.50 am)

MR BREALEY: Dr Niels, could we go please to bundle 3, tab 2. It is not your report, it is the report of Mr Harman. D3, tab 2.

It is not your report, it is the report of Mr Harman which starts at page 16.

A. Yes.

Q. What I would like to go to is section 9. Have you read

this section?
A. Yes.
Q. Have you discussed his evidence?
A. To a limited extent. I think Mr Harman and I pretty much did our analysis independently, but there was certainly communication between us.
Q. Well, in section 9, as I think you will appreciate, he goes through a fairly detailed account of the effect of a lower MIF on Sainsbury's costs. Do you accept that?
A. Yes.
Q. And so I won't go through it all but just highlight some passages. If you go to paragraph 9.4, 106.
MR JUSTICE BARLING: Is there anything confidential in this?
MR BREALEY: I am most grateful.
MR JUSTICE BARLING: Are you going to be able to ask questions about it without ...
MR BREALEY: This is actually quite important. I'm really sorry to the court, the Tribunal, but this is all in yellow, isn't it? Yes.
MR JUSTICE BARLING: Well, a lot of it is in yellow.
MR BREALEY: It is not going to be the same if I just ask Dr Niels to read it and me not make any submissions on it -- well, not submissions --
MR JUSTICE BARLING: You don't think you can conduct your questioning, or that Dr Niels can give his answers

properly?
MR BREALEY: No. I honestly would say yes if I could, but I really -- I'm going to get to the meat, I'm going to go to a document in a minute, for example, which is all yellow.
MR JUSTICE BARLING: I'm sorry, then, for those not in the confidentiality ring. We will take the notice off the door as soon as we possibly can.
This is Sainsbury's confidential material. There may be people who are not able to hear MasterCard material but are able to hear Sainsbury's. I don't know whether that applies to anyone here.
(11.53 am)
(End of open session)
(Beginning of yellow confidential session - REDACTED)
(12.45 pm)
(End of yellow confidential session)
(Open session)
MR JUSTICE BARLING: Could we take the notice off the door.
MR BREALEY: Dr Niels, if you go to tab 7, the bundle page 856, 21 at the top right.
A. Yes.
Q. I referred Mr Abrahams to the "make Sainsbury's great again" initiative that kicked off just as he was leaving. Have you read this transcript?

A. I think I read it at the time. Where are you on the transcript?
Q. Sorry, page 856, top of 856:
"Great food at fair prices supported by strong promotions."
A. Yes.
Q. We don't need to go to it, but he said:
"Answer: As I say, I was aware of the general initiative ...
"Question: Would you, reading that, accept that improving customer offer would essentially include quality, service and price ...
"Answer: Well, it doesn't say quality, service and price."
I asked again:
"Question: What would you understand ... by that?"
He said:
"Answer: Quality, service, price, availability, all of those different things."
Just pausing there.
Do you accept what he is saying there, that that's what supermarkets do: they compete on quality, service, price, availability all of those different things?
A. Yes, I agree with that proposition.
Q. Then if we could go to page 27, which is top right, 862 bottom right.
So you remember that what Mr Abrahams was talking about is that lower interchange fees can go into prices. It can go into marketing. It can go into promotions. Yes?
A. Yes. From those previous paragraphs, actually, I found those paragraphs to be kind of consistent with my economic assumption of high pass-on given the dynamics he describes there.
Q. Okay, we will come on to that then.
"Question: So what would marketing involve? Can you assist the Tribunal, what is involved -- what type of marketing would you be observing?"
If you could read that.
"Answer: It could be anything from new ranges being launched in the stores. It could be new ways of rewarding customers, it could be advertising on the television, radio, papers. It could be any of those things."
Let's just pause there.
Now, here we are talking -- you say in your report, what would happen if Sainsbury's got 20 million less in interchange fees? What is it going to do with?
In your report you say the exam question is: would that 20 million go into lower prices? That's what you

are trying to ascertain, isn't it?
A. Yes, my analysis focuses mainly on pass-on into price levels, yes.
Q. What you are saying is that if you can show that prices would have been lower, what you are saying is that if the interchange fees had been higher, then the prices would have been higher?
A. Yes.
Q. So we see that Mr Abrahams has said, well, what will happen if you get a decrease in interchange fees -- and I'm asking them this -- we will come on to it in a moment, but let's just pause there.
If Sainsbury's took that 20 million and had a new television advertising campaign, didn't put it into lower prices and had a 20-million advertising campaign, is that pass-on in your view?
A. Again, I think that's an interesting question. I am not sure actually if I can give a view on that, give a comment on that.
Q. Well, you are here to assist the Tribunal, Dr Niels.
A. Yes.
Q. This is actually a key point. I mean --
A. But I'm saying this because it is partly probably a legal question, as we discussed before, what is pass-on. So instead of -- In this case, a lower cost we

are talking about. So instead of lowering your price, which would be pass-on, you spend it on marketing. So it is the question, again, who bears the burden or who gets the benefit in this case.
I can't really say whether that's -- whether one would consider that to be pass-on. I think if -- marketing is probably more difficult than other costs, as I mentioned earlier. Economics can still say something about the effect of consumers of quality. So some of these other dimensions of competition between supermarkets. So quality, if, as a result of the extra money available, I don't know, Sainsbury's invested in making the shop look really nice, then in an intangible way consumers benefit from that as well. So that would be actually a way of pass-on to consumers. For marketing I think it is just a bit less clear.
Q. So --
MR JUSTICE BARLING: Economic theory doesn't help really on that?
A. Not much. Only to the extent that relationships between cost and prices and other factors that consumers look at like quality. Up to that point it can help.
So one reason why I have focused on price in my analysis is that that is the realm of economic theory. The other reason though is that while supermarkets

compete on many dimensions, price is a very important, if not the main, or probably the main dimensions at the end of the day.
MR JUSTICE BARLING: It would be a pretty odd situation, wouldn't it? Or would it? I don't know. No, sorry, that is not a fair question to put to you. It's not a fair question. It is not appropriate for an economist.
MR BREALEY: But again, it may be that you can't assist the Tribunal and economic theory doesn't help, but if there had been a positive decision in the light of increased interchange fees -- this is a hypothetical now -- to cut the quality of a certain product, so you were getting premium beef from Aberdeen and now you are getting it from somewhere else, but you have cut the quality of the product. Now, the customer hasn't got the quality that it used to have, but you cannot say that the customer is bearing the financial burden of that higher interchange fee. The person who has suffered is the farmer, if anything.
A. I think you can say that because price and quality are just two aspects of a product. You can raise price or you can lower quality. In essence, the consumer suffers in the same way. Economic theory can say something about that.

If, instead of your beef costing -- instead of the price of your beef going up, as in the example, it is actually now lower quality beef or maybe a reduced quantity or whatever, that is a detriment to the consumer. And therefore, that is a way for the supplier in this case to pass on the cost increase, because presumably lower quality means cutting costs.
So rather than shifting the price up or putting the price up, it reduces its cost by providing that same consumer lower quality. That would, according to economics, still be pass-on.
Q. It may be a question of law, but I put it to you if the rationale for pass-on is unjust enrichment, and we established that pass-on concerns the financial burden, so if you reduce the quality where is the customer bearing the financial burden of that? Where is the customer paying the overcharge to the retailer?
A. It is paying it in qualitative terms. So the company, rather than pass-on the higher cost to higher prices, has maintained its financial position by just cutting corners or cutting costs and offering lower quality meat. The consumer pays for that, in this case in intangible ways.
So this is where you can't quantify it directly in financial terms, but it is a burden that has been passed

on to the consumers.
Q. But not a financial burden?
A. Unless one were to quantify the detriment in quality, which sometimes economists can also try to do.
Q. But in monetary terms it is not a financial burden?
A. Correct.
Q. Correct. There is no transfer of money from the customer to the retailer, correct?
A. Correct.
MR BREALEY: I think that is a very good place to stop.
MR JUSTICE BARLING: Is it?
MR BREALEY: Yes.
MR JUSTICE BARLING: Right, we will see you again at 2 o'clock.
(1.00 pm)
(The short adjournment)
(2.00 pm)
MR BREALEY: I think we are in open court.
MR JUSTICE BARLING: Yes, we are.
MR BREALEY: Good afternoon, Dr Niels. Moving on to something new: exemption. Do you accept the need for robust and convincing evidence for the application of article 101(3)?
A. Yes, I think that is always desirable. If you have robust and convincing evidence.

Q. I asked whether there was a need and you said "desirable". I do not think there's anything between us. There is a need, isn't there?
A. Well, as an economist I would say as robust as one can do with available data. The need itself, that I think is a legal question.
Q. Okay. On the legal question, if you can go to E1, it is a legal consideration as to the threshold that your report has got to satisfy. E1, tab 15, which is the General Court. Again, you participated in various proceedings I think you said earlier on. I think you were acting for the Royal Bank of Scotland or for MasterCard or --
A. Yes, Oxera advised the Royal Bank of Scotland.
Q. And they intervened in these proceedings?
A. Yes.
Q. It is E1, tab 15. If you could go to page 343. Because, as you probably know, this was a ground of appeal, a complaint by MasterCard that the Commission had adopted too high a burden for MasterCard to prove exemption. Is that correct? Do you remember that?
A. I don't remember the details of that.
Q. At 343, the second plea, infringement of article 1(3), you can just read 194, 195. Then, when we get to 196, you see the General Court saying:

"The undertaking or association of undertakings claiming the benefit of article [what is now 101(3)] is to bear the burden approving that the conditions of that paragraph are fulfilled."

So that is the burden of proof.

Now we have the standard of proof:

"Consequently, a person who relies on article [what is now 101(3)] must demonstrate that those conditions are satisfied by means of convincing arguments and evidence."

So convincing arguments and convincing evidence.
A. Can you just guide me, which paragraph you are on?
Q. I'm sorry, 196.
A. Yes.
Q. So convincing evidence. That is the standard that the General Court has set out, that both -- well, the burden of proof of course is on MasterCard, correct?
A. Yes.
Q. And so your report, which is essentially the evidence that MasterCard is putting before the Tribunal, must adduce convincing evidence. Is that the standard that you have tried to attain?
A. Yes. Well, I always try that my economic analysis is as robust as possible, and therefore hopefully also as convincing as possible.

Q. You can put E1 away if you want. You know that 101(3) has four conditions?
A. Yes.
Q. You refer to them in your report?
A. Yes.
Q. I just want to see how you have approached these four conditions. If you go to bundle E2.2, tab 11. This is the Commission's decision. It is page 1186 I would like to go to. 1186. This relates to the first condition.

Have you familiarised yourself with what I'm going to take you to, 670, 671 and 672? Would you like to just read through that. This is pretty standard stuff when it comes to what you have to show on the first condition of 101(3). So if you want to familiarise yourself with it and then I can --
A. No, I'm -- it is standard, yes.
Q. It is standard, isn't it?

For example, in paragraph 670, you see it says:

"Firstly, it follows from the case law of the Court of Justice that only objective benefits can be taken into account. This means that efficiencies are not assessed from the subjective view of the parties."

That is, as you accept, standard?
A. Yes.
Q. That's what the European Court dictates:

"Cost reductions that do not produce any pro-competitive effects on the markets ...(Reading to the words)... profits are therefore irrelevant from the point of view of article 101(3)."

You have accepted that what this said at 671 is standard.

Can I just go to 672, which again, is in the guidelines, as we will see in a moment:

"All efficiency claims must therefore be substantiated ..."

And I put in brackets:

"... (by convincing evidence) so the following can be verified."

This is what you have to show as an exemption for the first condition, you have to show the nature of the claimed efficiencies, correct?

A. Yes.

Q. The link between the agreement and the efficiencies, correct?

A. Yes.

Q. The likelihood and magnitude of each claimed efficiency, correct?

A. Yes.

Q. And how and when each claimed efficiency could be achieved, correct?

A. Yes.

Q. Have you attempted to satisfy all those conditions when drafting your report on article 101(3)?

A. I have attempted it and I think there is convincing evidence of the efficiencies that credit card schemes bring and that the MIF brings, because the MIF is what allows credit card schemes to exist and to remain competitive and to be more competitive vis-a-vis other payment systems.

That is the nature of the efficiencies in a nutshell. So I have tried to review the evidence and put forward the evidence that is available on that.

There is I think, as also in other cases, there is only so far that one can go with economic analysis in very precisely quantifying or analysing the four conditions, so these conditions and also the others. Therefore, the bulk of my analysis under the exemption condition is about the acceptable methods to determine an exemptable level of MIF, so the cost base and the MIT -- the cost base method and the MIT. I accept that those methods do not directly, but I think they do indirectly, but do not directly address each of these conditions in such a logical step as is set out here.

Q. That is one of the criticisms, as you know, that Mr von Hinten-Reed makes, which is that you kind of

group it all together, say they are all satisfied, but without going through whether it improves efficiency, fair share, whether it is indispensable. You take that criticism on board, do you?

A. I think I try as much as possible also to put it in those four conditions, so the fair share, the efficiencies. And there is evidence on fair share that I discuss at length, and the efficiencies. But ultimately, I think both experts then try -- and even the Commission, actually, when it comes to okay, well, there is now a practical method to get an exemptable level of MIF, have to come up with some sort of proxy method, some rough method to an acceptable method to determine the exemptable level of MIF.

At that stage, yes, the refinements of where are each of the four conditions, they are not that clear any more. But I have in my report also tried to discuss the four conditions individually.

Q. But when you refer to the proxy, I take it that you are not excusing yourself from adducing robust and convincing evidence of the satisfaction of the link, the magnitude and all the things we have just gone through; that is correct, isn't it, or is it not correct?

A. It is correct, I'm not excusing myself. I think there is a link because both methods have inherent in them --

I mean, they are not just methods plucked out of the air. They both have inherent justifications for them in terms of efficiencies, the first condition, in terms of fair share, the second condition as well. So they are not completely divorced from the four criteria.

The two methods, I would say that is where most of the robust evidence has come in from both sides' economists. But they can be translated into the -- or translated back into the four conditions.

Q. But you have not analysed the four conditions separately?

A. I have in my report analysed the four conditions, one by one, before going into the two proxy methods. That's in section 4 of my report.

Q. That, with respect, is a general description of what you are doing, rather than setting out one by one how each methodology satisfies each of the four conditions, which is a general introduction.

A. I think it is more than an introduction. It sets out my key arguments. It is also in the joint statement. I have summarised the key arguments as to why I think each of the criteria is met. But I do accept that once I discussed the two methods, so it is in sections 5 and 6 of my report, I don't go back to the individual conditions. Because at that stage I think I have taken

the approach that also the European Commission had taken: there is an exemptable level of MIF and now let's try to come up with a sensible method that would approximate that exemptable level of MIF in line therefore with the four criteria.
Q. Staying with the first condition, I think we may need E2.2. I can't promise it, but I'll put it to one side for the moment. Could you pick up bundle E1, because I want us to stay with this first condition for a moment. I would like to go to E1.19. This is in the context of the evidence you just gave. It is E1, tab 19 at 436, and it is paragraph 232. Again, I would hope you are familiar with this because of the evidence you have just given.
A. Sorry, paragraph which number?
Q. 232, page 436 of the bundle. 232. This is the ECJ, the main Court of Justice:
"In the present case, it was open to the General Court to find in paragraph 120 without erring that the MIF was not objectively necessary for the operation of the MasterCard system. In the light of that conclusion, the General Court also correctly concluded in paragraph 207 of that judgment that analysis of the first condition laid down in article 81(3) called for an examination of the

appreciable objective advantages arising specifically from the MIF and not from the MasterCard system as a whole.
"It follows from this that the argument of the General Court wrongly ignored the advantages to cardholders resulting from the MasterCard scheme cannot be accepted."
I just emphasise the point, the first condition laid down in 101(3) called for an examination of the appreciable objective advantages arising specifically from the MIF.
Now, is that something that you have attempted to do?
A. Yes. In my report, my analysis, my logic is very much -- and I described this in detail in sections 2 and then section 4 -- my analysis very much is that without a MIF you wouldn't have four-party card schemes, or they would not be as competitive or as successful as they are today.
Therefore, in my logic, the benefits, the efficiencies that come from having four-party schemes but also having competition between schemes, so those efficiencies can be attributed to the MIF. I think I'm quite clear on that in my report.
Q. Again, I'm just referring to the evidence you gave a bit

earlier on which led me to this, when I asked you:
"Have you attempted to satisfy all those conditions when drafting your report on article 101(3)?"
You said:
"Answer: I have attempted it and I think there is convincing evidence of the efficiencies that credit card schemes bring and that the MIF brings, because the MIF is what allows credit card schemes to exist ..."
What actually is your evidence relating to the MIF specifically?
A. So in section 2 I have set out extensively the basic principles of two-sided markets, of four-party card schemes, and in my opinion very much it is the MIF that allows four-party card schemes to be competitive and to exist.
So the logical step in my mind is clear, that without a MIF you wouldn't have so much competition inter-scheme and you wouldn't have four-party card schemes to the same extent.
Therefore, the efficiencies that come from card schemes, and the various efficiencies, and you know there are a number, can be therefore attributed to the MIF. That is my opinion. And I have been clear on that in section 2 and also in the joint expert statement.
Q. Let's just tease this out a bit. Clearly -- and you

were part of the interested party, so you were part of the Royal Bank of Scotland team, as I understand it. Clearly, MasterCard, and as I imagine the Bank of Scotland, were arguing that the scheme created efficiencies, and that was rejected. So what was the argument that was being advanced there? In other words, what is the difference between efficiencies from the scheme and efficiencies from the MIF? There seems to have been a massive point of principle here.
A. I'm not sure exactly what was argued. I'm also not sure if what you were saying was followed, that the efficiencies were rejected. I think what I read in here is that one does -- or the court says one does need to distinguish between the efficiencies of the MasterCard scheme as a whole and the efficiencies of MIF.
In my mind, in my analysis, those two you cannot distinguish because it is the MIF that allows the MasterCard scheme to thrive in the first place.
Q. In other words, the argument was the scheme produces benefits, efficiencies. That was rejected. But you say, well, I have looked at the MIF because the MIF is necessary for the scheme and the scheme produces the benefits? Is that how it goes?
A. You are saying the argument that the scheme produces benefits was rejected?

Q. Was rejected.
A. Sorry, I had not understood that. I don't read that in here, unless I'm mistaken.
Q. Let's look at it again:
"The General Court also correctly concluded that analysis of the first condition laid down in article 101(3) called for an examination of the appreciable objective advantages arising specifically from the MIF and not from the MasterCard scheme as a whole."
That is exactly what the Commission said in its infringement decision. You have got to look at how the MIF creates the efficiency gain. It is not good enough just to say that cards are of a benefit.
A. Yes, I see that. But what it doesn't say here is that the court or the Commission rejected the fact that the scheme itself had benefits.
I think what I'm reading here is that it says here that that in itself, the fact that the scheme has benefits, is not enough. You need to look at the specific benefits of MIF.
But I can't see -- the question put to me has been twice that the fact that the scheme has benefits has been rejected here. I just don't read that in here.
Q. Dr Niels, we are certainly not saying that a payment

card scheme does not produce benefits. It produces benefits to all of us. They are a fantastic thing. But that doesn't mean to say that the fact that the scheme produces benefits, that MasterCard gets home on article 101(3). Because I'm trying to establish with you and ask whether you have done this, whether you have analysed whether the MIF itself has produced the efficiencies that you claim in your report. Have you gone down to that level of granular --
A. Yes. So I think I would agree that the scheme produces benefits. They are a great thing, credit cards.
From my analysis it also follows you wouldn't have all those benefits because you wouldn't have the scheme without a MIF. Four-party schemes, first of all, wouldn't have existed in the first place without any MIF, as you can read in the fascinating history of schemes in the Baxter article. But also more recently and in the current environment, I have shown in my analysis, in my report, that without the MIF certainly MasterCard wouldn't have been able to compete with three-party schemes and other payment methods.
So it is the MIF that allows four-party schemes to be competitive. I have discussed that also in detail in section 2 where I go back to the basics of interchange fee and two-sided markets in competition between

schemes.
In a nutshell, in two-sided markets like payment cards you get this skewed pricing structure. So there is a pot of money to be earned on the side of merchants and that then grows the scheme because you can give a good deal to cardholders so you grow. Amex does that. A four-party scheme does it, but the only way a four-party scheme can do it is by having this internal transfer. I know this also veers into the discussion on article 101(1), objective necessity, but from an economic perspective, to me that is quite a clear and convincing logic.
Q. But just to kind of nail this one down, does article 101(3) call for an examination of the appreciable objective advantages arising specifically from the MIF and not from the MasterCard system as a whole? Do you want me to say that again?
A. I think what you have just read out is the legal test, and I have no reason to disagree with that.
Q. Right. That's the legal test. Is that the test that you have tried to comply with?
A. Yes, I have tried to comply with that test and generally with the various legal tests under 101(3). But as I said earlier, there is only so far that you can go with the economic evidence in terms of precise analysis,

precise of each of the criteria under 101(3). And therefore at some stage -- I have discussed them one by one, but at some stage I have taken the same approach as the Commission and tried to come up -- okay, what is the question, what is a good method of an exemptable level of MIF? And that's where the bulk of my analysis under 101(3) has taken place.
MR SMITH: Dr Niels -- sorry to interrupt, Mr Brealey -- you said several times now that it is the MIF that allows credit card schemes to exist and to remain competitive. Why is it that one needs a default rate? Let's assume for the moment that some sort of price is necessary for the scheme to operate. But why can't that be a bilaterally agreed price?
A. Yes, I think -- well, that is a very good question. Possibly also -- well, a big theme and a long answer, but I try to keep that short.
I think in my logic -- as I said, two-sided market, you want to charge a bit more on the merchant side and a bit less on the cardholder side because that's the optimal. Let's say for the sake of argument that that optimises the size of this scheme. So Amex does that without any need for a MIF. In a four-party scheme you do need a MIF. The four-party scheme is organised such that when producing the activity of the scheme, certain

costs fall on the issuers. That's by scheme design. We have been through that in the evidence.

So some of those costs fall on the issuing side. At the end of the day, when you have -- if you still look at the scheme as a whole, you have got revenues on one side and costs on one side and revenues and costs on the other side. As if to make the scheme work, you want a transfer between the issuing and the acquiring side. So an interchange fee, I hope that's reasonably clear, is required, some transfer.

The next question is, okay, can you do that bilaterally or multilaterally? I think there are several advantages over multilateral. First of all, it is the transaction cost side of things. So if you have many acquirers, many issuers, it is much easier to do it at the scheme level. It saves transaction costs. In particular for international schemes that has been a big factor.

But also, and this is perhaps a more detailed discussion and a big theme under article 101(1), bilaterals you have that inherent problem, as has come up before, of this issue of -- so bilaterals without default MIF. You have that problem of the hold up, or hold out, or a Cournot complements problem.

I can go into details on what the problems of that

are, but in a nutshell that is not very attractive and, if anything, leads to even higher interchange fee levels. That's why the preference in most systems, even from a commercial perspective, has been a multilateral arrangement.

MR SMITH: Thank you. I understand the hold-up argument and I am sure Mr Brealey will come to it.

MR JUSTICE BARLING: Following on from that, you do explain in your report, I think, you certainly discuss it in your report, but why do you say in simple terms why would it be necessarily be higher? Presumably what we are envisaging here, someone is not having a MIF for whatever reason, whether regulation, so imagine the scheme without a MIF and others have a MIF, or the three-party scheme have something equivalent, so you have that imbalance there. And that's the background to what Mr Smith's question raised, was a question of a negotiation.

You say, well, that negotiation, economic theory suggests, would lead to something higher than whatever the MIF would have been?

A. Yes.

MR JUSTICE BARLING: What is the reason for that?

A. Back to basics on that and so most economic theories would agree that if you have no multilateral, so just

bilateral, so no default, you get negotiations.

In those negotiations the logic is that an acquirer -- with the honour all cards rule, which is another important aspect of a four-party scheme, with the honour all cards rule once the payment has been made at the merchant and that merchant's acquiring bank then has no option but to clear the payment with the issuing bank. It is at that stage that each issuing bank has a degree of market power, of monopoly power. It is perhaps the equivalent of the holder of a patent that you can't go round.

Economic theories say in that situation every individual issuer would try to extract a bit of that market power and therefore would negotiate an interchange fee that would be higher than what it would have been in the multilateral setting.

There are some follow-up questions that have come up in this case like, okay, does that lead the scheme to collapse or not? And thirdly -- the next follow-up question is: does a scheme therefore have to do something, like this ex-post pricing prohibition? I am sure we will come to that later, but the basic logic is it is this hold up, this market -- this individual market power by individual issuers at the point of the acquirer not having a choice but to deal with that

issuer to clear the payment.

MR SMITH: It may be a question of law on which we will be asking the parties' assistance, but suppose on the proper operation of the MasterCard scheme the issuing bank can't make a deduction to the monies that it remits to the acquiring bank without agreement. In other words, if there is no agreement the payment is nil. In other words, there is no hold-up.

If that's the position, and I underline the "if", then all you are saying about the difficulty with the bilateral "ifs" is that they involve transaction costs, there is no other disadvantage?

A. Yes, that is right. If a rule like that existed, then that's true. Then this market power would be constrained in a way.

Now, the difficulty I have with such a rule is that it is effectively saying -- it is also a restriction. It is effectively saying the interchange fee has to be zero. And it would again be a centrally imposed rule in my mind.

MR JUSTICE BARLING: But if that was the result of the negotiation, if you had that rule but you had negotiation as well, you still have the possibility of bilateral agreement, then everyone, on what MasterCard says, just migrates to the one that pays the MIF. You

have zero MIF in one, you have ordinary MIFs in another. But is that necessarily something that would have no effect in a negotiation? Do issuers want that? Why aren't issuers willing to pay something to avoid that if they would otherwise?
A. Yes, I think so --
MR JUSTICE BARLING: So why aren't acquirers willing to?
A. So you are positing a situation where there is this rule that you can't -- the issuer can't impose a charge or deduct anything but you can do a bilateral.
I think no issuer would have any particular incentives than to try to -- or let's put it first the acquirer. The acquirer wouldn't have any particular -- if the acquirer can get a zero MIF on an interchange fee in essence because of that rule, the acquirer wouldn't have any reason to then enter into the bilateral negotiation and say, well, do you want to bid more than zero?
MR JUSTICE BARLING: The issuer would have a strong --
A. The issuer has an incentive, but if the acquirer doesn't then you don't necessarily get --
MR JUSTICE BARLING: Then the acquirer ends up paying the MIF. They go to the wall and the acquirer ends up paying the MIF of the people who have a MIF. Wouldn't they realise that and think, well, we have got to pay

something? Wouldn't that lead to possibly a lower, but still --
A. I'm not so sure because I think from the issuer's perspective, the easiest thing would be to go to another scheme where, actually, you do get a MIF. So having -- it is not very attractive for the issuer either to --
MR SMITH: Dr Niels, aren't you assuming that effectively the acquiring banks are negotiating on behalf of the merchants because the interchange fee is passed down the line, we all understand, to the merchants and it is they who bear the cost?
So although the negotiation of the interchange fee would be between issuing and acquiring banks, effectively the acquiring banks would be responding to pressure from merchants to have a low or zero interchange fee. Would that be fair?
A. In that situation, yes.
MR SMITH: Now, we have all agreed, we have heard Mr Brealey say this, that this card schemes are wonderful things. Presumably merchants and therefore, through them, acquiring banks would be appreciative of the advantages of the schemes and the benefits of schemes. And wouldn't it be a little bit irrational of them simply to say, well, no, we are not going to negotiate, we will only have an interchange fee of zero? Why would they do

that?
A. Well, irrational or not, there's something about the collective, whether each individual incentives versus what they would collectively be the best outcome. Also I can't see this hypothetical where you have a negotiation, but one side -- so the issuing side has effectively their hands tied behind their back because they can't impose -- the default remains a zero. Because that's your hypothetical position, isn't it?
MR SMITH: Yes, my hypothetical is there is no MIF effectively.
MR JUSTICE BARLING: Or zero MIF.
MR SMITH: So if there is no MIF it is zero. So unless something is agreed one way or the other, the issuing bank gets nothing. That is the assumption.
A. Yes. So I think individually no acquirer would really be so enlightened to say, well, we do want this scheme to survive especially if there are competing schemes out there. So I'm going to be a bit more generous and allow this particular issuer to charge more than zero if I can actually get away with zero. I can't see --
MR JUSTICE BARLING: The issuers would want a payment because they don't necessarily want to immediately -- so they would want a payment and they would want as much as possible. The acquirer would have muscle because he

knows the MIF is zero, so the acquirer has some -- but the acquirer would surely realise, and so would his merchants, that if he pays nothing, then on MasterCard's argument you have the cliff, they fall off the cliff and all the market share goes to the one that keeps a proper MIF. Surely that's highly undesirable also for merchants because they are no better off?
Whereas if the acquirer agrees to pay something, albeit not necessarily as high as the other MIFs in the market, who knows, but leave aside the question of whether they have to pay more than (inaudible) in the market, but it seems to me it is an odd thing. You are saying they pay more in one sense, and then you say they will be able to get away with paying nothing, which means that that disappears and they end up paying Visa or Amex who may have a higher MIF.
I just find it -- I struggle too to understand this game play.
A. It is an interesting question. I think the difference must be in what an individual acquirer has an incentive at the moment versus collectively what would be good for all of them.
I agree collectively they may think if we all are too harsh then this particular payment scheme may collapse, and therefore we are worse off. But I don't

think individually when an acquirer does this negotiation in that setting will be so enlightened because the acquirer will think, I can either get zero, which means very low interchange, which means I can give a good deal to my merchant, or it can think, no, if I pay a bit more then the scheme will survive and therefore me and all my rivals are better off.

I haven't thought it through in detail, but I think --

MR JUSTICE BARLING: There are only half a dozen of them, aren't there?

A. Sorry?

MR JUSTICE BARLING: There are only half a dozen rivals. It's not as though we're dealing with a huge mass of people.

A. They are fierce rivals, so what is collectively good for them is not necessarily what they would be driven by when they negotiate individually.

I think somehow I feel that the key is there. It is a bit actually the flip side of the bilaterals situation, the situation where the issuers do have some bilateral market power without the multilateral interchange fee. Again, the logic of the models is, individually, those issuers would actually price very high, but collectively they might think but if we all

price too high then, like patent holders, for example, if we all price too high then we collapse our own scheme.

So there is that -- it is a bit of a mirror image of that.

MR SMITH: Let's assume one of the big acquirers -- as the Chairman has said, the market seems to be quite concentrated, there are about six large acquiring banks if MasterCard's table is to be followed -- and we have a negotiation between an issuing bank and an acquirer, and the issuing bank is saying you have got to pay me something, I would like a positive interchange fee with money going my way. Of course you are right, the acquirer could say no, it is in my interests to offer my merchant's the lowest price and so I want to cut the interchange to zero.

Wouldn't an acquiring bank have two thoughts at this stage? One would be the Chairman's point, that issuing banks can simply drift away to Visa from MasterCard and MasterCard effectively collapses as a scheme and the period of zero MIFs is a short and perhaps happy one, but very short. So in a sense one is destroying competition in the market for a very short-term benefit. There's that consequence, which acquirers would have in mind.

Secondly, wouldn't there also be an impetus on MasterCard to cut back some of the benefits that merchants receive through the operation of the card system? I'm thinking in particular of the guarantee of payment in the case of fraud or where the account holder doesn't have enough money in his or her account, these benefits. I'm leaving on one side things like the 30-day credit, but that too could be regarded as benefit. You would get a scaling back of the scheme. Again, isn't that something that an acquiring sophisticated bank would bear in mind?

A. Yes. So we are talking here actually about a scheme that is potentially quite -- so quite different from the existing one. So we have made a few changes. So there is this zero default. The default interchange fee is zero so you can't charge. I'm still struggling a little bit with that one, what the benefits of that would be. But let's say if that were the rule, I do still think that the individual acquirer would -- in individual negotiation -- because the zero is there for grabs. That is the default. No effort required. I do not think any acquirer individually would be so generous as to think to the greater good of everyone for the survival of the scheme.

Partly -- there is a bigger question of okay, what's

the acquirer's incentives here in the first place, but the acquirer is usually acquiring a multiple scheme. They offer payments for multiple schemes. So this choice -- the competition between payment schemes, the competition between, say, MasterCard, Visa and Amex is much starker at the issuing level where issuers have to make a choice: do I issue this or do I issue the other?

So in terms of incentives, the incentives are --

MR JUSTICE BARLING: Some issue both, don't they, or several?

A. They do, but then they can switch. This bit of customers gets Amex and these get -- they do have both. But on the issuing side, the question "Which scheme do I prefer" is much more a live question than for acquirers. I think in general terms that is sort of the first bit of the question.

The second bit goes into the -- what other changes can the schemes make? Or shall we stick to the first one?

MR SMITH: I was simply articulating that as a possible consequence of an acquirer insisting on a zero MIF. I wasn't suggesting as a counterfactual a dramatically scaled back scheme.

The only assumption I was asking you to make was only a bilateral interchange fee could be agreed and there would be no default, or a default of zero, if you like. That's all I was putting to you.

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

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

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

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

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

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

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

MR SMITH: Thank you very much, Dr Niels.

MR JUSTICE BARLING: Sorry, Mr Brealey.

MR BREALEY: No. Very interesting.

I'm not sure I have got any questions out of that. Thank you very much.

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

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

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

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

A. Yes.

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

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

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

A. Yes.

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

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

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

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

Then at 52:

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

That's essentially what you are talking to.

"In MasterCard, however, the Commission concluded that a collective mechanism that shifts costs between acquiring and issuing banks is not indispensable for the operation of a four-party scheme because issuing banks and acquiring banks can recover their costs directly via their respective customer group. Indeed, the MasterCard decision identified five comparable payment card schemes that successfully operate in different member states without a MIF."

Just pausing there. Do you disagree with the Commission's analysis there?

A. I disagree with the Commission's analysis there.

Q. Then going on to paragraph 53:

"Although a MIF is not necessary for the operation of a four-party payment scheme, in principle some MIFs may enhance the efficiency of a scheme and benefit its users. According to 101(3), restrictive agreements [that is the MIF here] that are caught by 101 are nevertheless valid if they contribute to improving ..."

And it sets out the conditions for 101(3).

Then 54:

"The MIF is an instrument that shifts the costs."

Then it talks about balancing, but then it also talks about:

"If you are going to claim these efficiencies, it must be based on robust and compelling analysis that relies...(Reading to the words)... the relevant consumers to consider for analysis of efficiencies on merchants and their subsequent purchasers."

Assuming that you are wrong on paragraph 52 and that you can have a four-party scheme without a MIF -- I think that then deals with your point about how you have to wrap up the MIF and the scheme -- do you then

accept that you have got to look at the MIF specifically to determine whether there are efficiency gains under article 101(3)? In other words, forget the fact that the MIF and the scheme are wrapped up into one, do you accept that you have to look specifically at whether the MIF produces the efficiency gain?

A. Yes, I agree.

Q. That was the first condition.

Can we go on to the second condition now of article 101(3). To do that -- you probably want to put those bundles away -- we will need bundle E1. I don't know if you have E1 there.

Just coming back to the evidence you gave a moment ago about why you disagreed with the Commission on the necessity for the MIF, if the EU regulators had reduced the MIF to zero, banned it completely, both Visa and MasterCard, would you say that the two schemes would collapse?

A. I think they would struggle in the competition with Amex and other three-party schemes that may arise. So in the hypothetical situation, you are saying if the -- well, the EU regulator, but also any MIF was zero, so also the UK MIF. Is that what you are --

Q. Yes, I'm saying that let's assume the UK regulator or the UK Government said Visa and MasterCard can't have

a MIF. Amex can, but they can't.

A. Yes, my position is they would both -- both schemes would certainly lose a lot of market share to three-party schemes. I don't know where it would end up ultimately.

But also the competitive situation would be a lot worse, I think. So competition in the interscheme market would be a lot worse. Competition in the issuing market would be a lot worse. Looking at it in the round, I wouldn't say it is a more desirable competitive outcome, that situation.

Q. But would they collapse? The competitive outcome is a completely different matter. Would they collapse? Are they absolutely necessary for the operation of a four-party scheme, that is the test?

A. They may collapse. You don't know where it ends up. Certainly if they exist in their current form they may avoid collapse by actually making changes to the nature of the scheme. In essence they could, from credit cards, try to become debit cards. In my mind that's not a very informative counterfactual, but those kinds of things are possible in the world where both of them had to set a zero MIF.

Q. If we go to E1, tab 2A, these are the guidelines from the European Commission. Again, MasterCard has referred

to these in the skeleton, so I take it that they are not in dispute. But I need to take you to them to see how you have approached your economic evidence.

You are familiar with these guidelines, I take it?

A. Yes.

Q. And we will come to them a bit later on on other matters, but if we go to paragraph 38, for example, 38A.7, so page 38A.7, this is at the start of the principles of the application of article 101(3). Some of them you have already accepted because they are in the Commission's decision.

If we go over the page at 38A.8, we have the first condition, and we will see there at paragraph 50 and 51 those same efficiency claims.

So at 51:

"All efficiency claims must be substantiated."

And we get again the nature of the claimed efficiencies, the link between the agreement -- here the MIF -- and the efficiencies, the likelihood of magnitude, how and when. So this is where the Commission is talking about the efficiencies.

If we then jump to paragraph 83, this is what I want to ask you about, which is page 38A.13:

"According to the second condition of article 101(3), consumers must receive a fair share of

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

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

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

Q. That is the second condition. What do you understand is meant by the third condition?
A. The indispensability?
Q. Correct.
A. Well, my understanding is that you have to show that the -- that bit in the agreement itself, or the agreement is --
Q. The restriction --
A. -- is indispensable.
Q. The restriction is indispensable?
A. Is indispensable to obtain the efficiencies.
Q. In other words, if the efficiency would occur anyway, the transaction would occur anyway, the restriction is not necessary?
A. Correct, not indispensable.
Q. So in your report you have calculated the exemptable MIF in two ways, as you have said. Basically I can call it the issuer's cost methodology and the adjusted MIT approach. Yes?
A. Yes.
Q. Can I go first of all to the issuer's cost methodology. I think you can put all the bundles away, but you will need your first report, bundle 3, tab 3.
A. Yes.
Q. The exemption section, as you said earlier on, I think

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

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

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

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

MIF based on the Edgar Dunn cost study, a UK MIF etc:

"Based on the Edgar Dunn studies for credit cards, a cost revenue balancing for credit cards would be around ..."

Then you give a percentage. I don't know whether it is confidential or not.

If you go over the page 5.84, 5.85 you set out a table, table 5.2. Again, the results, and the source: based on Edgar Dunn studies.

Then at paragraph 5.89, again the exemptable level of UK MIF based on the 2008 study would then be between whatever it is.

So it is fair to say that this whole section is squarely based on the 2005, but more particularly, the 2008 Edgar Dunn cost study?

A. I used the Edgar Dunn cost study as the data source for my cost-based approach. That is correct. So I rely heavily on the 2008 in particular Edgar Dunn study.

You referred to the whole section. There is also a long bit in the middle of section 5 which discusses the evidence on merchant benefits which then informs me in my assessment of, okay, I take the EDC cost data as given and as a starting point, and then I form my own view on how to allocate that to -- into a MIF with an eye on what's the evidence on merchant benefits.

Q. Staying on 5.89 then, we have, with greatest respect, a very long passage about the cost studies. And then the punchline, as it were, is at paragraph 5.89 where it says:

"Given the important benefits that merchants derive from these costs, it would be reasonable but conservative to attribute at least 25% or 50% of these costs to merchants."

So before we get to the costs themselves the punchline is that one paragraph, and on what basis does any reader get from this as to why you consider it would be reasonable to attribute a quarter or a half of these issuer's costs to merchants? What is the basis for it?

A. Yes. So as I have set out in the paragraph above that, we have these costs and we have evidence on merchant benefits. One has to take a view. It is clear one can't -- there are no hard and fast lines here, but I'm giving my view on this evidence.

I think it would not be right to attribute all of those costs of credit write-offs to merchants because clearly also cardholder benefits. So there is an element of judgment here on the fair share. But nor, importantly, do I consider it correct to say none of these costs should be included because none of them benefit merchants.

In my analysis, clearly these costs do benefit merchants. And then it is a matter of judgment, but actually in my table 5.2 I showed the whole range. So at the end of the day it is perhaps not for me to come up with the right judgment, but I'm showing in my table 5.2 what the resulting exemptable level of MIF would be under different weights you give to the extent to which merchants benefit.

So, in my view, indeed I cannot do more than say zero would be too extreme, 100 might not be right because cardholders benefit, so let's be conservative and say it is between 25% and 50%. That to me is a reasonable number.

Q. I think the Tribunal would understand that, that that is your estimate of what is reasonable. But what is it based on?

A. It is based on the logic I have just set out. There is strong, convincing evidence in my mind that merchants also benefit from the credit extension, the extension of credit and the interest-free period to cardholders. And therefore, the logic of this cost base method is to look at three heads of issuer cost that also benefit merchants, and then it just comes down to a question, well, to what extent do they benefit merchants?

And one has to come up with a value judgment there.

That's as far as I can go, is to give my judgment at 25% to 50% is conservative. There is at that stage no hard and fast rules to draw the line somewhere, but I am clear that it shouldn't be zero.

MR JUSTICE BARLING: Is that a convenient moment for a short break?

MR BREALEY: It is.

(3.17 pm)

(A short break)

(3.27 pm)

MR BREALEY: If we could go back, what have you got there? D3?

A. Yes.

Q. If you go back to paragraph 5.4, which we saw a minute ago, it is the last sentence of 5.4:

"I have no reason to doubt these cost studies have been carried out in a robust and objective manner. I understand they were subject to an independent audit by Ernst & Young."

Now, that may be true but do you accept that these cost studies are not robust for you to undertake a calculation for these proceedings?

A. No, I don't accept that. I think this is -- to me this is robust and relevant evidence. This is after all the method that has been in place for more than 30 years,

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

Q. Did you look at any underlying documents or did you just accept what Edgar Dunn had done?
A. I did not look at underlying documents of Edgar Dunn. So I relied mainly on this document itself and then my understanding of the method which had come across before.
Q. Let's see what Mr Sidenius said about the robustness of this data for use over such a period of time. How many years are we talking about?
A. So we are talking here about a damages period of nine years, end of 2006 to -- or end of last year.
Q. So at page 1390, page 19 of the transcript, so I asked the question it is dated 2008, probably relates to 2007 data.
It is line 7:
"Answer: That is correct."
That is at paragraph 35.1 of his statement. There was -- it was a January 2006/2005 study:
"Question: ... Would that have related to 2004 data or 2005 data?"
He says:
"Answer: The 2005 report would have been 2004 data ..."
So I asked the question in line 15:
"Question: So why are you updating the data? One is 2004, one is 2007. Why are you updating it?
"Answer: Because -- you are asking a question that goes back nearly 40 years in time ..."
Then he goes on, and I let him go on, if you remember, about the NaBANCO case, which is fair enough.
But then we get to page 1392, so page 21 of the transcript.
At line 7:
"So every time you wanted to revisit on a periodical basis the interchange in the market to ensure it was correct, there would be a requirement to undertake a cost study."
This is his evidence:
"Answer: So from Edgar Dunn's perspective that is where our methodology originated from. We looked at if there is an imbalance in the card payment system, it must because there is probably something on the issuing side that is of value to the acquiring side. We tried to quantify those; we came up with the methodology we currently apply.
"Whenever this methodology was applied in the given market we believe, and we strongly advised our clients, that it would be wise to apply this periodically to update the numbers to ensure you were in line with the market. Because there would be things that are changed,

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

"Question: If I was doing a calculation for an interchange fee today, I would not be relying on this cost study because, as you say, interest rates change and all that sort of stuff?

"Answer: I would agree.

"Question: In fact, it would be rather foolish to calculate an interchange fee based on this cost study?

"Answer: Yes, I think it is outdated."

What is your reaction to that?

A. My reaction is that it is indeed somewhat unsatisfactory. We have a nine-year damages period and for the cost based method we have data for one year. As it happens, it is the first full year in the period.

Ideally, one would have liked more data and this is then for the exemptable level of MIF and for the damages calculation.

A similar thing to be said for the other methods, the MIT, where the only proper or decent data source that they are using is the 2015 EC merchant cost study which has data for 2013. Again, not entirely satisfactory that you don't have data going all the way back from 2007.

Q. Sorry, Dr Niels, I just want to interrupt. As you know Mr von Hinten-Reed has tried to analyse the data going back some years, correct?

A. But only Sainsbury's specific data, that's why I said the only proper source is the EC merchant study, which is the survey of many merchants.

Q. I am concentrating on the robustness of what you have relied on. The reason for that is it is MasterCard's burden of proof to prove an exemption. It is not for Sainsbury's to prove any exemption. So I need to know from you whether you accept that the data you have relied on is robust and convincing for the purposes for which you have used it?

A. Yes, and I think it is. So what I'm saying is this is again both for exemptable level and for the damages calculation. I accept it is somewhat unsatisfactory that for both methods you have only one year of data. Ideally one would have liked more. But nonetheless I think -- well, I certainly still rely on -- sticking with the cost study, I still rely on that cost data. It gives a good indication of what it costs -- what costs would have been in those years.

I was not in a position to redo or update the cost studies, so this was the best available data. I did look a little bit into, well, if these costs move, as Mr Sidenius has signalled, what direction would they have moved? As I flagged up in section 3 of my report, if you look at the biggest cost item in there, which is the credit default cost, I don't think that's confidential, I flagged it in section 3 of my report. I referred to data from the FCA, that between 2007 and 2010 those default costs went through the roof, I mean, record levels.

So that tells me that if anything, in the subsequent years the total costs that Mr Sidenius would have produced would have gone up. But that is as far as I can go. I accept that I have not updated, or I was not in a position to update the 2008 cost study.

Q. Let's take this in stages. Keep the bundles open, but can you go to bundle E2, please, tab 6. This is a MasterCard document. We have seen it before. It has attached to it a report, an economic analysis by Professor Weizäcker, and that starts at 362. This is the MasterCard notice of appeal 2005.

It has an economic analysis of the MIF at 362, which is a similar sort of thing that you are calculating. If I go to 380, paragraph 92 he says -- this is the Professor. This is the basis upon which he is relying on robust data from Edgar Dunn:

"The starting point for setting the default MIF is to take into account those costs which reflect a conservative estimate ...(Reading to the words)... providing a payment guarantee."

The very same costs that you are dealing with.

93:

"These costs are determined by a cost study performed every second year by a specialist independent firm of consultants."

Edgar Dunn & Company, the EDC cost study.

So it is MasterCard's own view that these cost estimates have to be, or should be updated every second year for the very reasons that Mr Sidenius gives in his evidence, both in answer to a question that I posed and both in answer to a question that Mr Justice Barling posed, that things change. You accept that.

I think you have accepted that it is unsatisfactory that you are relying on 2007 data to calculate a MIF for a nine/ten-year period. You have accepted it is unsatisfactory?

A. Yes, it is unsatisfactory, but I still rely on the results. What I don't know from here is one implication of the question is MasterCard did this every second year. I can't recall. What I have seen is the cost studies in 2005 and 2008. So that is three years.

I don't know factually whether Professor Weizäcker is correct here, but clearly, yes, there was a need to do this periodically. I can see the commercial rationale for that.

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

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

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

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

taken to these three paragraphs because I have referred certain witnesses to them. It relates to interest.
The second assumption is that issuing banks bear the majority of the costs of the system. Do you see that? Yes?
A. Yes.
Q. You must have read this before?
A. I have, yes.
Q. So the second assumption is the issuing banks bear the majority of the costs of the system. As you know, the Commission said that issuers' revenues had to be taken into account. That was apparently appealed, and the General Court said:
"With regard to the second assumption, as the Commission has pointed out, in essence recital 686, it is sufficient to note that it is based on a partial presentation of the issuing and acquiring business, taking into account only the costs borne by the issuing banks and omitting the revenues or other economic advantages they obtain from credit card issuing business notwithstanding the latter's importance."
See paragraphs 106 to 108.
106 to 108 is at page 332, which relates exclusively to the UK market, as you have probably seen.
So we established this morning that you looked at

the judgments of the courts to guide your economic analysis. The question that I'm sure you know I'm going to ask is why have you not taken into account the substantial interest that banks earn, and other economic advantages from credit cards?
A. I think, well, there is various angles to this. I think this particular point here in 211 is a criticism of the cost method that I think misses the point because there is a justification for the cost method despite it not explicitly accounting for issuer revenue.
I can go through the justification of the cost method and I can go through the question of revenues as to why or -- in what context they are or are not taken into account. Because I think it is a bit too -- it is a bit cutting corners to say the cost method doesn't directly incorporate revenues because that is correct. But that misses the point of why a cost method is justified.
I think it goes back to the principles. If we are in 101(3), exemptable level of MIF or the damages calculation, so what would be a reasonable exemptable level of MIF? In general, when you want to sort of regulate a product or determine a fair price, there are two main ways of doing it. One is to look at the product's costs and the other is to look at the price of

benchmark or comparable products.
So my cost-based method is looking at cost, and that's not uncommon in regulation. Most utility regulation is cost based. The MIT method which I also applied is more looking at the benchmark price. So that criticism, looking at cost doesn't take into account revenues, I do not think it is a valid one at that level.
On the issuer revenue question, clearly issuers also make revenues, but the whole principle of interchange, so going back to Baxter and also then the EDC cost methodology, is even taking into account those issuer revenues, so you look at all the revenues on the merchant side, the costs on the acquiring side, you look at all the revenues from the cardholders and the costs to the issuers, even then you have an imbalance in this four-party system. So despite the issuer revenues. And the MIF is a mechanism to allocate that.
So from that perspective, from the origins of the cost, even the cost method being a proxy for the imbalance does take into account issuer revenue from that perspective.
Q. But --
A. Let me then continue on the issuing revenue because it is a big theme.

You can look at this in three stages. Conceptually, empirically, what is actually the evidence on issuer revenue, and normatively, should issuer revenues be the be all and end all.
Conceptually, in a two-sided market a scheme may decide, look, there is a pot of money to be had from merchants, on the merchant side and from cardholders, and let's suppose the optimal, like any two-sided market you get the skewed pricing structure, so let's suppose it is right that we charge this to merchants, this amount, this MSC of 1%, say. Amex does that, the four-party scheme wants to do it as well.
So there is a pot of revenue on the merchant's side, and clearly there are revenues on the cardholder's side. But there is no -- that is the balance of the scheme, and then you look at cost and revenues and you find, okay, with this level of revenues on the merchant's side, acquirers actually getting a good deal out of this and that's not the right balance within the system. So let's reallocate through the MIF.
Because you shouldn't forget that, yes, issuers get roughly -- I don't know if this is now confidential -- between 70% and 80% of the scheme's revenues are on the issuing side. So that is the issuer revenue. The rest is on the merchant's side. But -- maybe this is

confidential -- we saw the percentage of costs, and more than 95% of the costs are incurred on the issuing side. So the issuers have 95% of the cost and 70%, 80% of the revenue, so there is an imbalance.

Conceptually that's where a MIF comes into play. Then I think the argument from the other side is: but those issuer revenues in their own right, might they be big enough, even if you have an imbalance, forget about that, might they actually be big enough to fund all those issuer costs? So are the issuers making a lot of -- getting all of that revenue and actually the scheme can function just by the issuers paying for their own costs?

I think, first of all, there is no evidence, as was also established with Mr Sidenius. So no one has ever really fully analysed, well, how profitable is issuing? But from the FCA document, and we may come to it in more detail, but that was published in November last year, so after the expert reports, but one does get a clear impression that there is a lot of competition on the issuing side, including competition on the interest rate. You get lots of these zero balance transfers, low rate offers etc.

That to me suggests that, yes, it is profitable on the issuing side but not so profitable that you can fund

the entire, basically the entire scheme cost. And the FCA also concluded that there is no indication that currently there is a cross subsidy from -- so interest revenues from revolvers to transactors in the scheme.

My third point, apologies for the length, but normatively one would also raise big question marks. Is it even desirable to have a scheme where everything is funded out of issuer revenues? For the scheme it probably wouldn't be desirable. It is not the business proposition that 40% of all cardholders who are revolvers fund the entire thing. It is also not clear whether a scheme like that would survive in competition with other schemes.

Secondly, again, from reading the FCA, the FCA as a regulator would be quite worried about a scheme that subsidises the whole scheme out of 40% of cardholders who are revolvers.

So that is my take, if you like, on interest revenues.

Q. Let's just try and draw this to a close, then. Do you accept or do you disagree with what the General Court has said, that when you are looking at the issue of whether issuing banks bear the majority of the costs of the system, which is the thrust of almost the whole of your report, that the issuing banks bear the majority of

the costs of the system? Do you disagree with what the General Court said, or do you accept that when looking at that you should include, or not exclude or not admit from your consideration the interest payments and the other revenue? In other words, do you agree with what the General Court has said, or disagree?

A. I think it is not out of -- it is out of -- in a way I disagree therefore, is the answer, because the cost method is what it is. It is a cost method. It doesn't directly take into account issuer revenues.

If the court is saying you should also look at issuer revenues, well, the answer to that is then there is another method, maybe we are then back into the overall, the fallbacks studies that EDC has also done where it did try to look at all revenues, all costs and at that imbalance. And that's where we got those percentages from, the 70%, 80% of costs on the issuing side -- sorry, 70%, 80% of the revenues, but 95% of the costs, and hence there is an imbalance taking into account issuer revenues.

Q. Just, again, you have said I think in evidence that you disagree with what the General Court has said. I'm looking at section 5 of your report. Is it correct to say that you have omitted from your analysis in section 5 any analysis of revenues and other economic

advantages issuers obtained from their card issuing business? Have you omitted revenues and other economic advantages that card issuing businesses obtain in your analysis? Have you omitted it?

A. Yes, in the sense that section 5, I apply a cost method as a way of getting to an exemptable level of MIF. And interest revenues do not feature in the cost method.

I think I do give the rationale for the cost method, which is the rationale I explained earlier, that it is in a way -- it tries to be a proxy for also this cost revenue imbalance.

But I did not look at issuer revenue explicitly in section 5, correct.

Q. Would you accept with me it is rather unsatisfactory that you are giving your rationale for that halfway through this trial in cross-examination rather than in section 5 of your report?

A. No, I disagree. I think there is a good rationale which I explain for the cost for doing a cost study and for doing a MIT, which -- the MIT approach which the Commission has been emphasising, which incidentally also does not explicitly look at issuer revenues because it has a completely different basis. It is a price -- cost benchmarking exercise. It also doesn't look at interest revenues.

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

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

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

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

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

MR BREALEY: I think if the students are coming tomorrow morning, they will be okay. But then I'm going into, really, stuff that is confidential to MasterCard. I have got to sort Maestro out, for example. So that is pretty historic, but --
MR JUSTICE BARLING: The morning looks as though --
MR BREALEY: I will do my best so they get their hour's session.
MR JUSTICE BARLING: And also for the benefit of anyone who is here now who needs to know. All right.
I think there are some questions for the witness.
MR BREALEY: Okay.
MR JUSTICE BARLING: Is it convenient to take them at this stage? I hope so.
MR BREALEY: Absolutely, yes.
MR SMITH: Mine is not a question for the witness, but a request for the parties.

Questions by THE TRIBUNAL

PROFESSOR JOHN BEATH: I have a question. It goes back to this thing about if, in the cost-based method, you should take account of revenues which you generate from interest.
I was thinking to myself what would William Baxter have made of all of this, because if you think back to the original model, what he is doing is building up

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

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

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

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

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

(4.30 pm)
(End of open session)
(The court adjourned until 10.30 am on Friday, 26th February 2016)

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