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

Day 17 Redacted

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Friday, 26th February 2016
(10.30 am)
(Open session)
MR JUSTICE BARLING: Good morning Dr Niels.
A. Good morning.
MR JUSTICE BARLING: Good morning Mr Brealey.
MR BREALEY: Good morning.
MR JUSTICE BARLING: As you know we have got some visitors this morning --
MR BREALEY: Yes.
MR JUSTICE BARLING: -- from the university. Can I just say before you start, I'm pretty sure there won't be any problem given where we are at, but we have to finish pretty sharply this afternoon, at about probably 4.20 pm would be the latest I think.
MR BREALEY: I think it is an absolute racing certainty that we shall finish before then.
MR JUSTICE BARLING: Well done. Coming from a racing man, I will rely on that.
DR GUNNAR NIELS (continued)
Cross-examination by MR BREALEY (continued)
MR BREALEY: Good morning Dr Niels. I'm going to move on to the second of your proposed methodologies for exemption, that is the adjusted MIT approach, yes?
A. Yes.

Q. We don't have to go to it at the moment but that is in section 6 of your first report at bundle D, tab 3, page 310. We will be going to it but D3, tab 3, page 310, the second methodology is in section 6.
On the adjusted methodology I understand you are prepared to adopt the information in the Deloittes report but with certain adjustments, is that correct?
A. Yes.
Q. In essence you make three adjustments, if I can just go through them and then we will look at them. First, you prefer the scenario 3, whereas the Commission and Mr von Hinten-Reed prefer scenario 2?
A. Yes.
Q. Second, you exclude large merchants from the survey?
A. There is an adjustment in terms of merchant size, yes.
Q. And third you take again the increased sales point but this time you use Amex as a comparator rather than just purely cash. I know you mix Amex and cash up, but Amex is a comparator rather than just cash?
A. Well, I should clarify, that third adjustment is actually two different things. One is the fact that there are online transactions for which cash isn't the right comparator, so I have used other comparators, PayPal and Amex in particular and then the second of those adjustments is an adjustment for the credit

function, to recognise the credit functionality of credit cards and therefore the right comparator there is merchants providing credit themselves, so store cards in essence and there I have used Amex as a proxy for the costs that merchants would incur to provide credit themselves. So that is also where the Amex numbers come in.
I should also clarify that I have made those three adjustments indeed to the EC cost data, but when I talk about adjusted MIT there are also a number of conceptual adjustments I have made to the whole concept of MIT, or to how the European Commission has interpreted it.
Q. Okay. Now, what I want to do, I think you accept that those in broad terms are the three adjustments, yes? I understand that in section 6 there is a lot more detail to it, but they are the three adjustments, and I just want to establish the differences. If we can go to bundle A, tab 1. Now, this is Sainsbury's' opening submissions at tab 1 and if you go to page 82, this is where we deal with your adjusted MIT approach. So paragraphs 233 to 251. Now, I'm obviously not going to take you through our submissions, I will take you through the evidence, but what I would like to establish is the reasons that they are increased and to what. So, if I, for example, take paragraph 238, if you just read

that, where you favour scenario 3 -- and I don't believe the percentage is confidential? No.
So what I'm trying to establish is the importance of the disagreement. That's essentially what I just want to establish at the moment, the importance of the disagreement. And at 238 we have set out -- it is based on Mr von Hinten-Reed -- the difference between scenario 2 and scenario 3 doesn't really amount to very much.
Now, these were put in opening. MasterCard has not challenged them. Clearly if you do, you and Mr von Hinten-Reed may have to have a chat. But as we understand it at the moment the difference between scenario 2 and scenario 3 essentially would take Mr von Hinten-Reed's percentage from 0.15 to 0.2. Have you any reason to disagree with that? So just taking his approach, but taking the scenario 3.
A. I think the difference is a bit bigger than that. I would have to go back to my own calculations and to the calculations referred to here, but if the question is about the importance, it is -- this adjustment is in essence the question: do you consider fixed costs as part of the MIT. That is part a fundamental conceptual question. I think there are very good reasons why fixed costs should be included and I think it is also

recognised by the Commission itself that if you include fixed costs, the cash has a lot higher costs than just the variable costs because cash has a bigger fixed cost component than credit cards.

In a nutshell the reasons why I think fixed costs --

Q. Sorry Dr Niels -- I don't want to stop you but all I'm trying to establish at the moment, otherwise my racing certainty won't finish, is just the importance of the percentage increase. This is all I want to focus on at the moment; not what is in your section 6, just the importance.

A. So if I can have a quick look at my numbers because I think I discussed this in my report and also at Mr von Hinten-Reed's calculation in his table 7, because then I can --

Q. Maybe we can cut this short and you can do that at the short break, but if I just take you where I'm going. So paragraph 238 --

A. (sotto voce) Could I have my report please?

Q. Okay, you can do it now if you want to.

A. Not the detail but it is helpful for me to have my own report in front of me.

Q. Of course, yes. You want the first report?

A. Yes.

Q. So Ms Love reminds me that at page 339 of the bundle.

Does this help you? Page 126 of your report, 339 of D3. All I'm trying to do at the moment Dr Niels is work out the importance of the differences and at the moment I'm putting to you that according to Mr von Hinten-Reed the difference between scenario 2 and scenario 3 is not that great -- obviously we have got to deal with it, but it only leads to a marginal increase on his percentage.

A. I will come back to it.

Q. Okay.

A. My impression was that the difference is a bit bigger than that but I will come back to it.

Q. Okay, that is the first adjustment. Then the second adjustment is the exclusion of the large merchants and if you go to paragraph 244 of the skeleton, at our opening submissions, according to Mr von Hinten-Reed it does increase the MIF significantly. So it is going from his 0.15 and now it is going to 0.45 to 0.73. Does that ring any bells or would you like to also take stock of that over the short adjournment? All I'm trying to establish is the significance of excluding large merchants.

A. Yes, if you look at my table 6.4, there are three columns, low, medium and high, and I think they are the main -- so, the adjustments -- so the adjustment that I make for this question of is it the average

transaction or the average merchant, I prefer average merchant and therefore I make the adjustment because the Deloittes survey is clearly biassed towards the very large merchants. So having made the adjustment I made, you can see the difference in my table 6.4, that if I am not mistaken the two columns to the right are already adjusted with the -- have already made the adjustment for large versus -- for taking out very large merchants. So you can see leaving the very large merchants in, that is the low estimate, so the first column of numbers you get -- at the end you get 2.23 and then the adjustments, one of the adjustments leads to 0.45 and the other scenario is the high estimate leads to 0.73 which is probably the same 0.45 and 0.73 here.

Q. Right.

A. So, yes, that is the difference that the size adjustment makes. And I will come back to it but I think the difference then still raises the question of what's the difference between 0.45 and 0.73 and I think that is to do with the other adjustment that we just talked about whether you take the medium -- sort of the medium term scenario or the long run scenario. So maybe the difference between 0.45 and 0.73 answers the previous question as well, but I can come back to that to confirm.

Q. Okay. So that is the second adjustment and then the third adjustment, which I will call the Amex point, the additional sales and the Amex point, you can see this at paragraph 246, "online sales and face to face transactions" and the adjustment for online adds another 0.27 and the adjustment for face to face adds a further 0.29. Again, this is based on Mr von Hinten-Reed's calculations, we mentioned it in opening and we haven't had any push back, but maybe it is something you want to verify over the short adjournment?

A. No, I think at the end, after those adjustments I end up with a MIT range between -- so a MIT-MIF range between 0.73 and 1.05. That's in my table 6.11. And that is indeed after having made all the adjustments, so the incremental difference, if you like, is probably thereabouts, so 0.27, 0.29, but again to be clear, I wouldn't label that the Amex adjustment, it is two adjustments, it is one to capture online as a relevant -- where other payment methods are relevant comparators including Amex and the credit facility point adjustment -- the credit facility adjustment, so this is two adjustments.

Q. I call it the Amex point, Dr Niels, because you are not taking cash solely as a comparator now, you are taking Amex.

A. I'm taking Amex and PayPal for online and the idea is in line with Rochet and Wright that for the credit facility you take store card costs or merchant credit provision costs; as a proxy for that I have taken Amex.
Q. Good, right, so that is that established. Could we go to your first adjustment. One of the reasons you have rejected scenario 2 is self-selection bias, correct?
A. Yes.
Q. Could you go to bundle E3.6 please. You will need E3.6 and you will need J2, which is the transcript bundle. So E3.6, tab 126, which is our famous MasterCard 2008 cost study, do you have that?
A. Yes.
Q. And J2, which is 28 of the transcript, 1399. It is tab 11 page 1399, page 28.
Now you were in court obviously, you told us yesterday, when Mr Sidenius was giving evidence, correct?
A. Yes.
Q. So, if you go first to the 2008 UK cost study.
A. Yes.
Q. Internal page 7. Page 2504. I took Mr Sidenius through this. Have you read this?
A. Yes.
Q. Have you re-read it after the evidence that Mr Sidenius has given?

A. No.
Q. You will see there that there is a data collection process and quality assurance.
A. Yes.
Q. And you see at the bottom:
"Edgar Dunn draws on its extensive experience in payment services, utilises statistical methods ..."
It goes on. Second paragraph over the page at 2505:
"Upon receipt of the completed questionnaires EDC undertook a review of the data quality based on statistical analysis of the returns and our market experience."
So this whole section is dealing with how Edgar Dunn looks at the quality of the data, do you accept that?
A. Yes.
Q. If you go to the passage of Mr Sidenius' evidence at page 28. Have you read this?
A. I was in court when he said this.
Q. Have you read this since the --
A. No I haven't.
Q. So I took Mr Sidenius to this page 7, which is dealing with how the quality of the data is checked. So I say:
"Question: If you go to page 7, as with many studies you have to check the quality of the data. So as I understand it, you are telling the reader, me and the Tribunal and the others ... that you draw on your extensive experience in payment service and utilised statistical methods basically to validate the quality of the data.

"Can you assist the Tribunal how you go about ensuring that the quality of the data is achieved?
"Answer: Yes.
"Question: But why is that? Is that because of some sort of self-selection bias? The issuers here know the reason that they are giving the data, I guess. They know that it is going to go and form the basis of an interchange fee?
"Answer: You could argue that. In our case I think it is just as much if we are going to put our name on a study you want to make sure that that data is correct. We are not just going to accept what people tell us."
So there I am putting to Mr Sidenius that you are getting data from the issuers, the banks, and arguably there is the same self-selection bias. They know the purpose for which it has been provided, that is to say the level of an interchange fee; do you accept that?
A. Well, self-selection bias is I think slightly different concept but if you -- if the question is about do issuers, at the time when they submit data to EDC, do

they know what it is for; yes, I accept that.
Q. If you go on. Rather than me read it out, if you want to read it. (Pause).
A. No I'm fine.
Q. We will go over the page then at 1401, where I ask him:
"Question: So you are looking for outliers, are you?
"Answer: We are looking for outliers as well as understanding the organisational structure of them. You know, how big is the department they're running and how many applications ...
"Question: I see. Even after that, drawing on your expertise, as I understand it you get the cost study audited by, or you did, by Ernst & Young; is that right?
"Answer: As I said, this was the EC Commission that requested that the study ... it was a complete independent process.
"I think Deloittes -- no, it was Ernst & Young ..."
So Ernst & Young, he got it wrong, it wasn't Deloittes, it was Ernst & Young, audited the data.
My simple question to you Dr Niels is why would you reject the Deloittes data on self-selection bias when you rely on a report which has the same capability of self-selection bias? It just works the other way.
A. I think comparing the two studies, there is a very

significant difference between the two. The EDC cost studies is, as we saw yesterday, an established methodology, has been carried out periodically for 30 plus years. EDC has developed a really good understanding of the issuer's costs. Probably the issuers as well they know what sort of costs, what the categories mean when they are asked for that and there is a process in place for verification, for independent audit indeed. Looking at that, in its own right, I think that that was for me good enough reason to say I rely on this data. The merchant cost study is a completely different story, there were grave difficulties in getting the data, which was one thing that has been acknowledged by the European Commission. Still it is the best data that there is, but there were great difficulties. The response in itself had an element of self-selection, as in it was in the end they ended up with the larger -- with much more larger merchants and I also made adjustments from that. But also importantly this was the first time ever that someone did an exercise like this. It took them many, many years, but importantly it hadn't been done before, no one had asked before "Okay, what exactly, what type of costs are we after?" and in particular asking the merchants themselves to make this separation themselves

between fixed and variable cost of cash handling, where normally, in their normal course of business, probably they don't look at it that way. That is what caused some difficulty and that is what I pointed out, the difficulty it seems to have been taking place at Sainsbury's as an example of that. It is very hard to ask merchants: well do it yourself, this fixed versus variable.

So that was one of my reasons why I would rely more on the overall cost data in the merchant -- in the EC merchant cost study and therefore in the long-term the econometric -- the third scenario -- it just takes the data overall, and therefore doesn't rely on this self-selection by merchants of what is fixed and what is variable.

So that was one reason but I think actually my other and probably my main reason for preferring the long-term scenario that the Commission analysed is this point about I think fixed costs, or long run marginal costs if you like, is the right basis for the MIT.

Q. But on the self-selection bias point you are simply not giving any credit whatsoever to the team at Deloittes, the economists and the team at the Commission for checking the quality of the data, are you? You are not giving any credit?

A. I'm giving credit to the -- Deloittes didn't play the same role as EDC in the issue, there wasn't that same interaction. It is my understanding that Deloittes just was given the data from the surveys as it was, there wasn't then a interaction between Deloittes and the merchants. So I'm not criticising Deloittes for this aspect. And then I'm giving the economists at the European Commission a lot of credit because the economists said, well we can also look at this data econometrically and that is the bit in the EC merchant cost study that I then rely most on.

Q. You say you are giving them credit but the economists at the Commission don't actually like scenario 3, they prefer scenario 2. You are not giving any credit to them whatsoever?

A. I don't know whether it is the economists at the Commission who then prefer at the end scenario 2. I think the Commission in the end, yes, prefers scenario 2, but from looking independently what the Commission has done, I would prefer scenario 3. And probably some economists who did this in the European Commission might also be happy with their analysis.

Q. You also exclude large merchants and so on this could we just go back. So you have got E3.6, you have got the transcript bundle. If you go back to internal page 4,

page 2501 of the cost study. So the "Sampling methodology":

"The overall objective of the sample selection was to achieve a representative sample of the issuers across which to measure the interchange costs. As with every sampling exercise this involved a trade-off between the additional cost of collection information for a larger sample and the improvement in accuracy of the results that would be obtained from increasing sample size."

I put this to Mr Sidenius but I will just go on:

"Given that the cost of collecting relevant information from issuers was unrelated to the size of the issuers in terms of proportion of transactions and that the incremental cost of adding issuers to the sample was significant, the proposed approach focused on the largest issuers in order to limit the overall number of participants while ensuring the sample included a significant proportion of the transactional volume in the market."

They give the benefits for that. Then at the bottom, "Selection of participants":

"In other regulatory environments, MasterCard has aimed to measure a majority of transactions in the market to provide a statistically valid sample. For example, MasterCard Europe has agreed with the

European Commission that a representative sample for undertaking a cost study in a given market would be achieved if the participating banks would account for at least 70% of the transaction volume in the market. Edgar Dunn & Company has applied the same rationale for the selection of participants in the UK market."

Now, just pausing there. I understand that those names in table 1 are confidential. If you then go to what Mr Sidenius said about this when I asked him. So if you go back -- this is now page 24 of the transcript, page 1395. If we pick this up at line 12. This is the sample size. Then I read it out. Then over the page at 1396, line 6.

"Question: So there you are concentrating on the largest issuers and transactional volume, correct?

"Answer: As part of the selection for the study, yes.

"Question: Then you go on, I will ask you about this ..."

Then I read out what I have just read out in court and you can see what he says at the bottom:

"Answer: That goes back many years ago. That was when we started ..."

He goes on, if you want to read that. Then picking this up at 1398, page 27:

"Answer: So in reference to this, the 70% was a minimum requirement. We have tried always where we could to go higher than that --

"Question: Pausing there. 70% was sufficient for a robust study?

"Answer: Well, for the purposes of the Commission. But you should compare that to markets such as ..."

And he goes to Norway, and then down at line 17, I ask him to look at table 1, which is the confidential table which I have just referred to:

"Question: There is seven is there? There is seven. They are the issuing banks. I mean, they seem quite large to me."

I'm saying:

"Question: Clearly in the UK, even at that time, you had other banks."

Then I set out the various other banks:

"Question: Why pick those big seven and exclude the smaller ones?

"Answer: We are seeking representative samples of transactional activity. That's what the Commission asked us to do and that's how we chose the sample.

"So as you can see, this was over 90% of all the domestic transactions in the UK. That would be, in all instances I have come across, deemed to be a very representative sample."

So again I'm emphasising here the large people:

"Question: So picking the largest you thought was a representative sample?

"Answer: Yes."

Again, you are relying in your report on this report which has taken large issuers as a representative sample. So why do you exclude it when you rely on the Deloittes survey?

A. I think again there is not really -- it is not really the right comparison. In the issuer cost study I think again it is an established method etc and the idea is to get a good picture of what the issuer costs are. In terms of 'are there biases therefore'; well, possibly. If there is a significant bias from looking at the largest merchant, then probably it is that -- sorry, at the largest issuers, then probably it is that the smaller issuers have higher costs, if anything, I think Mr Sidenius has also said that in his evidence.

So if anything the result of the EDC, if there is such a bias indeed -- although he also I think says there isn't such a difference, but if there is, then if anything the costs that come out of the EDC cost study are too low because if you include all the smaller issuers of higher costs you would get a higher number.

So there is no risk also from my perspective and I rely on these numbers that we somehow produce a MIF that is too high.

For the -- coming back to the MIT, to the EC merchant cost study, it is a different -- it is a whole different -- it is a very different situation. What you are after there is the average merchant. We are not after some representative or typical transaction value. So in that context saying "Oh we just take the largest 80% of merchants", which is sort of what they got, or merchants, the very large merchants representing 80% of all transactions is not good enough for MIT purposes because it doesn't give you a good feel for what's then the MIF. So if you rely on that entire sample, which is biassed towards the large merchants, you are going to clearly underestimate the MIT because you are -- because those larger merchants have much lower cost of cash handling than smaller merchants.

Even within the sample, as we have seen in the evidence of the merchant cost study, you could also see that the very, very large merchant had a much lower cost of cash handling than even the still large but somewhat smaller merchants.

So that was for me enough basis to say well, if you had included the even smaller merchants, your cost of

cash handling would be much higher and therefore your MIT would be much higher. Therefore I felt that it was correct to make an adjustment for size, taking the EC merchant cost data, but making adjustment for size to incorporate -- to take account of the fact that smaller merchants who were not included in the survey would have on average substantially higher cost of cash.
Q. We will come onto the average transaction in a moment, but I will ask you this question: if you are wrong on that and it is correct to take the average transaction, do you accept that you are then wrong to exclude large merchants?
A. The average transaction. So, yes I think that is incorrect for MIT, but let's say, let's take the proposition --
Q. It is a simple question Dr Niels.
A. So I have -- so my adjustment is still based on the full sample, but it excludes the cost of cash of the very, very large merchant. So I still have in there, in my MIT, the other -- so the size 6 and size 7 category merchants, between 20 and 200 million revenue. So it is basically my MIT, my adjustment there is their MIT based on their cost of cash handling as mentioned in the survey.
Now, if they in the survey represented the typical

transaction, as was ours, then that is still captured in my MIT. So what I'm getting at is I have excluded the very largest merchant. If the average or typical transaction takes place at those, then, yes, I accept that I have excluded it. But if the average transaction takes place among merchants in size 7, 6 and 7 category, then I still capture the average transaction.
PROFESSOR JOHN BEATH: Could I just ask for a clarification. In making your adjustment for large merchants, did you exclude all the very large merchants?
A. Yes.
PROFESSOR JOHN BEATH: So in a sense what you have done is to truncate the distribution of costs, haven't you, by getting rid of the very largest ones?
A. Yes.
PROFESSOR JOHN BEATH: Why didn't you leave some of them? Because after all what you are after is the average merchant. Could you explain to me why you did what you did?
A. Yes. In essence, you have to make some -- you have to draw the cut somewhere, so I thought it was cleanest to just --
PROFESSOR JOHN BEATH: You chopped off the top end of the distribution.
A. Yes, because what we are missing is the other very large

tail end of the distribution of the very small merchants, which isn't in there at all. I thought therefore the middle bit, indeed the truncated middle bit, so merchants of categories 6 and 7, I have taken those as more likely to be representative of the overall average than even with some of the very large merchants included.
PROFESSOR JOHN BEATH: I understand your argument now.
MR BREALEY: If you can put that bundle away, E3.6, and take out E2. Have a look at another survey that MasterCard has undertaken. E2, tab 3. Now this is an annex. I do not think this is confidential. This is DotEcon economic evidence. This was submitted to the OFT. Do you recognise this document?
A. Yes.
Q. December 2003. Referred to this at 115 is a merchant survey. We haven't -- we were refused disclosure of the whole survey, but we can pick it up on this description of annex 1. But I note yesterday you said that Oxera or you were involved in some sort of merchant survey. Is this the merchant survey you were involved in?
A. No, we did a separate merchant survey at the time in probably just even before 2003, but this was done by DotEcon but not by us. DotEcon were advising Mastercard International in the OFT proceedings.

Q. But you were aware of the survey at the time? Your client was MMF.
A. Yes.
Q. So if we look at 115. This is a survey. We don't -- unless you want to explain we don't have to go to the nature of the survey, the purpose of the survey. It was rejected by the OFT and the European Commission, but I'm interested in how it was conducted. So this is a merchant survey undertaken by MasterCard. Page 115, paragraph 93:
"The sample was drawn randomly from the set of UK merchants sold directly to consumers turnover 55,000 or more."
So probably the small corner shops are excluded:
"The sample was drawn ... sampling from 100 plus... The survey was designed by PwC executed by MORI [and] a total of 502 merchants completed..."
So that is how it starts. If one goes to paragraph 100 on 117:
"In order to provide data from organisations of different sizes as defined by turnover, interview quotas were set. These quotas were not pro rata."
There you get small, medium and large.
"The sampling, 101, was designed to oversample merchants with high turnover. If a purely random sample

had been selected without quotas being set for size of business only a small number of organisations, with an annual turnover of 10 million or more, would have been interviewed. While such organisations account for a large proportion of all UK sales they represent only a small fraction of individual businesses. Within each of the three turnover categories companies were conducted randomly with the exception that for large companies a small number of key companies, eg the large supermarket chains, were added to the sample. Such companies account for many billions of sales and it was therefore considered important that each had the opportunity to participate in the study."

If you continue with this theme, at paragraph 111, at page 125:

"As noted above, the sampling method was designed to ensure that larger merchants who account for a greater proportion of all transactions are well represented in the survey. This inevitably leads to some over and under sampling, not only in terms of turnover balance but also in terms of the representation of different sectors."

But again Dr Niels this is an example of MasterCard doing a survey and emphasising the importance of large merchants, do you accept that?

A. Yes. This is -- again one has to look at the objectives of the survey. So this survey -- and I can't recall the details, but my understanding is this DotEcon exercise was done with I think two main objectives in mind: one was to assess the competitive constraints that merchants imposed on the scheme, so it was that whole question of restriction of competition, is there competitive constraint, because that was a relevant question at the time in the OFT proceedings; and the survey is designed to get a good picture of merchant benefits in general. So from those object -- with those objectives in mind I think it is reasonable at least to get a good representative sample and also to get the larger merchants representing more transactions in the survey, because then you can get a good feel for okay how big is really the total merchant constraint on schemes, or, you know, what are the merchant benefits overall. But for the MIT exercise, the objective is different. It is much more important, because we are after the average merchant, at least in my opinion, and then it is -- then having representation for the whole merchant sample is very important.

So that is a different objective. I don't think -- I think that's where the comparison between the two stops.

Q. You can put that bundle away. We will have a look at the objectives in a moment. Go back to your first report at D3, tab 3. Page 319, paragraph 6.39.

You are looking after, as I understand it, the small merchants, are you, at 6.39? You say:

"A further reason why setting individual or very specific MIFs is inappropriate is it would disadvantage smaller merchants who have higher costs of cash and would have correspondingly higher MIFs as well. In practice smaller merchants already tend to pay higher MSCs but the MIF is generally the same."

As I understand it, you don't want small merchants to be disadvantaged by higher MIFs, is that correct?

A. Well, I think this is one of the reasons why it is preferable that one looks at an average -- that one sets a MIT-MIF for the -- that applies to all merchants on average. It is not that I particularly want to protect small merchants but this is a good policy or economic reason for not distorting competition by having let's say Sainsbury's -- let Sainsbury's have a very low MIT-MIF because their cost of cash handling is lower and let the corner shop or the Tottenham restaurant have a very high MIT-MIF because its costs of cash handling are much higher. So I think there is a reasonably commonly accepted principle that what we are after and

also what the Commission and also the interchange fee regulation is after, that we have one MIT -- one MIF for the whole market.

Q. By excluding large merchants you are ensuring that the small merchants now pay a higher MIF. In other words, if you include the large merchants, the corner shop, the small restaurant in Tottenham pays a lower MIF; that is correct isn't it? If you include the large merchants, the small restaurant in Tottenham will pay a lower MIF?

A. If you --

Q. Include the large merchants, as Mr von Hinten-Reed has done, the small restaurant in Tottenham will pay a lower MIF?

A. So, yes, if you include the large merchants and get a very -- so get a much lower MIT-MIF then the average is lower, that is correct, I agree with the proposition. And therefore -- but still the very large merchants still pay -- are paying a MIT-MIF that actually covers their cost of cash, but the smaller merchants are still paying -- are still -- still have a higher cost of cash handling for it.

But yes, maybe so as not to complicate matters further I agree with that proposition, yes.

Q. Let's just have a look to see how the Commission has treated this. Could you go, I don't know -- what

bundles have you got there? Have you still got E2 there?
A. I have my own report, the transcripts and E2.
Q. You can put E2 away. You will need E3.10.
So this question of large merchants was something that the Commission was aware of; you accept that do you?
A. Yes.
Q. So at E3.10 we have at tab 202 our trusted survey, the Deloittes European Commission survey.
A. Yes.
Q. If you go to page 4324, the relevant paragraphs are 120 onwards. You have obviously read these before, have you?
A. Yes.
Q. So at 120 the merchant population is heterogeneous, the merchants differ in respect to several characteristics, we know that. At 121:
"For this reason it was decided to limit the number of characteristics that were going to be reflected in the sample. DG Competition decided to focus on surveying large merchants. Two main reasons supported this choice, first, large merchants are most likely to be able to provide the necessary data. Second, focusing on large merchants would maximise the coverage of the

samples in terms of transactions and in this way to enhance the liability of the outcome."
So they are aware of it. Then you will see at 122 that:
"An argument often made with respect to merchant's cost of payment is that they exhibit economies of scale and thus large merchants have considerably lower costs of payment than smaller merchants."
And that you would agree with.
"Several stakeholders ..."
Is that including you, MasterCard? Do you know who he pointed out?
A. I don't know.
Q. Anyway:
"Several stakeholders pointed out that surveying large merchants only will provide an incomplete picture of costs and possibly a biassed estimation of MIT-MIF. It should be noted that this potential bias would not necessarily result in lower MIT-MIFs since such economies of scale might concern both cash and cards. In particular, as the Commission also concluded in its decision, the acquirer margin under card payments was higher for small merchants than for large merchants, which implies the existence of scale effects for merchants on credit card transactions."

You see there at footnote 55 that DG Competition carried out a stakeholder consultation on the methodology which proposed surveying large merchants.
So the Commission was well aware of this issue and it decided that it was preferable or desirable to select the data from the large merchants and do you disagree with paragraph 122, where the Commission says it is not necessarily the case that MIFs would be lower and that small merchants would affect the overall outcome?
A. I disagree. In theory it could be right but actually the actual data that has come out of the survey, and we have seen that in the evidence actually, confirms that there is significant economies of scale, significant differences in cost of cash handling, even taking into account the card costs, because even when you look at the MIT, the implied MIT-MIF level between very large merchants and then the smaller merchants in the sample, there are significant differences. While in theory this statement here might hold, the actual data that has come out of the survey confirms that there are significant differences even in the survey sample.
Q. Remembering, Dr Niels, that the burden of proof of this is on MasterCard, have you undertaken a study taking the large merchants as identified in the Deloittes survey and placed on top detailed data relating to small

merchants?
A. No, that was the big unknown, the big absence of data on any data on small merchants. I think that data is just isn't out there. Everyone is struggling with it. With that fact. The Commission is aware of it, as is clear. We are aware of it. Still, I found it unsatisfactory to just therefore rely on the sample because while the Commission is aware of it, they then don't make any further adjustments and I found that bit unsatisfactory. So I did make the further adjustment.
The burden of proof on the defendants I think there is the beautiful symmetry with the damages overcharge. I also very much did this analysis as part of my assessment of damages. So the beautiful symmetry where calculating the exemptable level of MIF also gives you the calculation of the overcharge.
Q. If you go to bundle D2.1, which is where you will find Mr von Hinten-Reed's second report. Tab 3, page 526, paragraph 506. He, unlike you, has at least tried to factor in smaller merchants. So 526, at the bottom. He has taken the large merchants as the Commission has done and he says at paragraph 506:
"As a sensitivity check I consider how the MIT-MIF for credit cards would be affected by the inclusion of small merchants, assuming that they account for 25% of

retail sales based on the Eurostat data. As I mentioned earlier no data is available for the cost of payments to small merchants. In my sensitivity analysis I consider two scenarios, the MIT-MIF for small merchants being twice as high and three times as high. I apply this sensitivity test to three MIT-MIF estimates."

Then he says at 507:

"The results are shown in table 7.7. As can be seen, including small merchants and assuming for them an extremely high MIT-MIF does not change the results dramatically."

Now, have you any basis to challenge that? Have you attempted to challenge that in your reports?

A. Well this was Mr von Hinten-Reed's second report and I haven't had a reply on that since, but I clearly disagree with this adjustment. I think it is an inappropriate adjustment. So both Mr von Hinten-Reed and I -- well I tried it in my first report, Mr von Hinten-Reed in his second report, we tried to adjust for this size issue or to do a sensitivity check. I have done it my way as explained. This sensitivity check, the reason why I fundamentally disagree with it actually is in the assumption that the MIT-MIF for small merchants being twice or three times as high, when we saw clearly from the data, and maybe we can have a look

at it again, but even in the full sample in the EC merchant cost study, there were already significant differences, much more than 2 or 3 times, there were differences, 5, 10, even 20 times. So to say that the even smaller merchants have 2 or 3 times higher costs of cash I think is inappropriate. It should be a lot higher and I have given actually an example in my second report why this adjustment actually significantly understates the resulting MIT-MIF.

Q. Don't you, as an expert economist, recognise that the approach of taking large merchants and then sense checking it by reference to small merchants is preferable to just ignoring all the large merchants?

A. I don't agree that that is the right characterisation of what I have done. What I have done is to say we have a sample which is biassed towards the very large merchants, let's truncate that and that's a better indication of the overall size, including the small merchants, the big chunk that we don't have. I think this adjustment here requires some guesswork, some assumption as to: okay, if you include the small merchant, well what is their cost of cash? No one knows, that's the unsatisfactory part. But what I do know for certain is that it will be -- the cost of cash of smaller merchants will be more than 2 or 3 times

higher than that of the larger merchants.

I have included, I believe, a numerical example showing that in my second report, that very rapidly -- if you assume something higher than 2 or 3 times as high, then you rapidly get a much higher MIT-MIF.

Q. Let's see what the effect on the data is excluding your larger merchants. If one goes back in Mr von Hinten-Reed's second report to page 523, paragraph 489. Let's just see what effect your approach has to the robustness of the data. He says:

"I note that excluding the largest merchant seriously limits the reliability of results and their applicability to the UK. 130 merchants out of 256 included in the sample observation belong to the largest group, excluded by Dr Niels. Excluding the largest merchants reduces the sample size by more than half. Given that the sample is already small such an operation seriously reduces the reliability of the results as also shown by our lower R2 values. In the total sample UK merchants account for 10% of merchants but for 40% of total sample turnover. Out of 27 UK retailers in the sample 19 belong to the largest size group. Thus the MIT-MIFs obtained for the whole sample are largely influenced by UK retailers and can therefore be expected to be relatively close to the UK MIT-MIFs. By excluding

the largest retailers Dr Niels also removes most of the UK sales from the sample. Therefore, the MIT-MIFs obtained by the smaller group are likely to bear little relationship to the MIT-MIFs for even small UK retailers. According to Eurostat data, in 2013 69% of retail turnover in the UK was generated by retailers above 200 million turnover, while retailers with turnover between 20 million and 200 million accounted for 9%. Even if the MIT-MIF estimated for those smaller merchants is representative of the UK, which is unlikely as argued above, it is difficult to justify ignoring the MIT-MIF for merchants representing almost 70% of transactions."

Do you not agree that it is undesirable to ignore for the purposes of the UK MIT-MIF merchants representing almost 70% of transactions?

A. I disagree with these conclusions here. I think there is agreement that an adjustment is needed for size because not making any adjustment, in my opinion, certainly would be incorrect for the reasons we have discussed.

There is not a lot of information to decide which adjustment is the most appropriate one -- that is unfortunate but it is a fact. I think my adjustment, it is quite clear, yes, it then throws out the very largest

merchants, I'm clear on that, and yes, a lot of those were from the UK, I'm clear on that. I still think that my truncated average is more likely to reflect the average MIT in the market overall.
Q. Just to conclude on this point and then maybe we can have the short break. Just picking up on the average transaction, you have majored on you have got to look at the average merchant not the average transaction. Do you still have E3.10 in front of you?
A. Yes.
Q. Tab 202.
A. Yes.
Q. Page 4315, paragraph 82:
"Merchants in this population are likely to be heterogeneous ...(Reading to the words)... process and payments need to be taken into account."
The simple question is, are you disagreeing with the European Commission here that it is the average transactional benefit that is relevant not the average merchant?
A. I think the principle of MIT is that you are looking for the average merchant in the market. I'm not sure whether the distinction here is drawn very precisely between average transactional benefit or average merchant. I think what we are after with the MIT-MIF

approach is the MIT-MIF for the average merchant.
Q. If you still have Mr von Hinten-Reed's second report, at 525, he deals with this point in some detail. Again he interprets Rochet and Tirole completely differently to you. 496:
"The rationale for the MIT-MIF methodology is to measure the transaction efficiencies. Efficiencies are measured in terms of reduced costs of transactions. Efficiencies are about incremental costs."
497:
"In their original paper Rochet and Tirole conclude that when merchants are heterogeneous in the sense they derive different benefits from replacing cash by cards, the MIT-MIF should be based on the average transactional benefit amongst the merchants."
So he and the Commission are at one, not only in applying the average transaction, but also in interpreting Rochet and Tirole. Again I put it to you, are you disagreeing with the approach of Mr von Hinten-Reed and the European Commission?
A. I think Rochet and Tirole elsewhere also talk about "average merchants" and generally I think they talk -- or the literature talks more about average merchants rather than the average transaction value. The concept of average transaction benefits I think is again --

again it is generally worded, that could still apply -- or that still leaves open the question, are you talking about the average merchant or the merchant where the average transaction takes place.
MR BREALEY: If that's a convenient moment?
MR JUSTICE BARLING: We will have a short break.
A. I said I would clarify something, can you just remind me of the reference in Mr von Hinten-Reed's report, because I think --
MR BREALEY: Sorry, the reference of what?
A. There was a question about whether the impact of the adjustment from fixed and variable costs, 0.15 to 0.2, you pointed me to your opening statement with a footnote to Mr von Hinten-Reed's --
(Pause).
MR BREALEY: I'm told by Mr Cook it is footnote 266.
MR JUSTICE BARLING: If you want to try to find that reference for Dr Niels and then he can look it up in the break. We will have a short break.
(11.40 am)
(A short break)
(11.50 am)
MR JUSTICE BARLING: You found the bit you were looking for?
A. Yes, I have. If I may briefly. So the question was what is the impact of that first adjustment, so looking

at fixed or variable costs rather than just variable. I think the best indication for that is table 6.4 in my first report.
MR JUSTICE BARLING: Yes. Table 6.4. Do you have a page reference? Here we are, page 339.
A. Yes. I think the best way to look at it is there between the medium estimate and the high estimate, so the second and third columns. The MIT-MIF that results is 0.45, versus the 0.73. The difference between those scenarios is whether you take the Commission's medium term middle scenario approach or you take the Commission's long-term econometric approach. So that is is in essence the difference. So in my analysis it produces -- the makes the difference from 0.45 to 0.73 basically.
MR JUSTICE BARLING: More costs become fixed in the long-term?
A. Yes, so more fixed costs become variable in the long-term, so you --
MR JUSTICE BARLING: Yes, exactly.
A. Yes, so you account for them. But this is still what the Commission itself did. It is just that I prefer the third approach from the Commission over the second.
If I compare that then with what was put to me, table 7 in Mr von Hinten-Reed's report -- that's

table 7.6.
PROFESSOR JOHN BEATH: Which is?
A. In his second report on page 520. In that table you can see -- I think there the point was if you make the adjustments, you go from 0.15 for credit card, so the far right number in the bottom, to 0.20.
Now, so that is one adjustment but that is not the full adjustment. I think this is still in Mr von Hinten-Reed's own analysis which is based on Sainsbury's and what he does here is test for the sensitivity to a different cost allocation by Sainsbury's itself. That gives you one difference. But it is still in the context of the medium-term approach that the Commission -- which he relies on.
PROFESSOR JOHN BEATH: That's scenario 2?
A. Yes, scenario 2. I prefer scenario 3. So the effect of that first adjustment is the difference mainly between scenarios 2 and 3 as per my table. So it is a bit bigger than just going from 0.15 to 0.2.
MR BREALEY: So what was the difference in the end? I missed that sorry.
A. It is in essence the jump in my numbers from 0.45 in table 6.4 at the bottom, to 0.73.
Q. So if you take Mr von Hinten-Reed's approach and all you do is -- so you take the cost of cash, you take the

large merchants, but all you do is take scenario 3, rather than scenario 2 -- I'm sorry. If you leave all the large merchants in and the only -- I tried to establish at the beginning there are three main adjustments, yes?
A. Yes.
Q. Scenario 2 versus scenario 3?
A. Yes.
Q. Large merchants, what I have called the Amex point --
A. Yes.
Q. So let's assume that you are wrong on Amex, let's assume that you are wrong on the merchants and you adopt everything that Mr von Hinten-Reed has done, all you are doing is taking scenario 3 rather than scenario 2; what difference does that make to his calculation?
A. So yes, for that first adjustment it is in essence going from the Commission's scenario 3 to the Commission's scenario 2. I have shown the effect. You can also look actually at the Commission's own results which are probably sort of -- they also show the difference. So in paragraph 19 of the Commission's study you can also see that the Commission itself gets higher results for scenario 3 when they do the econometrics. So those results go up to 0.47. If the question is what difference does it make to Mr von Hinten-Reed's

assessment, I can't answer that question right now. I think the adjustment that I was shown here is just an adjustment to Sainsbury's allocation of fixed and variable costs. So that is part of it. But it is still within the scenario 2 scenario.
Q. Maybe we will try and get some common ground between you. Quickly on the third adjustment, just to sort that out, the third adjustment, what I have called the Amex point, you put forward a third adjustment to the MIT-MIF whereby Amex is the comparator and not cash -- I know there is a mix but Amex is through there the whole piece -- and this applies to online and face to face credit; correct?
A. Yes, so it captures two elements, online and the credit functionality of credit cards, yes.
Q. You are aware that the MIT-MIF as calculated in the Deloittes report and as calculated by Mr von Hinten-Reed and as calculated in the interchange fee regulation, so the MIT-MIF that they arrive at applies to online sales. So they apply the MIT to online sales?
A. I believe that is right. I believe that they measure it on the basis of the cash versus card comparison. I think they -- the Commission explicitly says "Well we couldn't do a merchant cost study for online", so it is a card cash comparison based MIF, but my understanding

is also that the MIF in the regulation 0.3/0.2 applied to all transactions, so again we have one MIT-MIF, including online.
Q. So it is not as if online are excluded from interchange fees, it is just that online is a slightly different calculation and the regulators have taken the cash comparator and applied it to online sales, correct?
A. Correct. I found it possible to actually make a more explicit adjustment or measurement of payment methods as compared to other than cash for online payments and that's what I have done. That is part of my third adjustment.
Q. You are aware that Mr von Hinten-Reed regards this as something of a windfall to the card schemes, because he says that a MIF is not necessary to achieve any efficiency gain within the meaning of article 101(3). He says you don't actually need a MIF for online sales, they would happen anyway. So there's no efficiency gain, but for reasons of practicality, it will be applied. That effect is, according to him, schemes obtain a windfall.
A. From an economic perspective, I see that differently. I think the principle of the MIT-MIF is that you set a regulatory price or fair price or exemptible price. With reference to the cost of -- or the price of

comparator payment systems, so alternative payment systems, the next best alternative, this idea of online would happen anyway, I think that's then -- that's not right because clearly there are still costs to that. So I think it is right that if we are talking about online payments, you have to apply the same principle of benchmark pricing regulation, so you look at the next best alternatives, and for online payments they are Amex and PayPal we have taken. Now the fact that that actually makes the MIF higher, so because the cost of those alternatives, PayPal is more expensive to merchants than credit cards, generally, you may call it a windfall or it has been compared with Kafka, Kafkaesque, but I think it is only Kafkaesque if the cost of the next best alternative, say PayPal or Amex online, is higher then it is perfectly efficient that you are allowed under this price cap approach to price all the way up to that level. So I do not think it is wrong that including online payments where alternatives are more expensive leads to a higher MIF.
Q. At paragraph 6.82 of your first report you say that online merchants gain a large benefit from accepting cards. As we established yesterday, it is not the right question. It is not the question whether cards are of benefit, the question is whether the MIF leads to

an efficiency gain. That is the question isn't it, whether the restriction of competition, the MIF, is necessary to achieve an efficiency gain?
A. I understand that that is the question for the legal assessment under article 101(1), but when we are talking here about what's the right economic approach to MIT-MIF, and following the same principles why someone may like the MIT-MIF and cash as a comparator, following those very same principles, I think it is consistent then to also look at online because it does benefit merchants at the end of the day and there is a cost involved in providing credit card services also for online payment. So it is only fair that the MIT-MIF in that same logic should cover also the relative costs to merchants for online payments and not just cash as a comparator.
Q. Have you included in any calculation the cost to the merchants of accepting online payments?
A. Yes, I tried as an approximation to look at the costs to merchants of the alternative methods for online payments, so Amex and PayPal. I have described that in my report.
Q. The actual cost that merchants incur for online payments, that Mr Rogers refers to in his witness statement?

A. I don't think I had much more basis than -- much more specific information for merchants for these purposes than looking at what my understanding was of PayPal and Amex.
Q. On face to face, as I understand it, your evidence is that the Amex based MIF is based on a notion that for some transactions the customers may not have enough cash, is that correct?
A. Yes, that's in line with the --
Q. The academic articles?
A. The Rochet and Wright thinking, which recognises that credit functionality has a benefit to merchant and there the next best alternative is actually not cash but for that type of payment it is other credit that would have been extended to the consumer at that point.
Q. So you and the academics are basically saying, as I understand it, that every merchant that accepts a MasterCard is effectively operating a store card?
A. Yes. In that approach of Rochet and Wright, the effective comparator is a store card. Now, clearly not all merchants operate store cards but nonetheless the concept of store card, and within that I have then taken Amex as a proxy -- as a conservative proxy because I think the real cost of providing a store card would probably be a bit higher than just Amex. But, yes, the

comparator is that the retailer somehow would have to provide credit, otherwise that transaction would not take place. So whether the retailer actually provides store credit or would have to do something else, the premise of the theory, which I agree with, is that the comparator there is not cash for those transactions but credit provided by the stores themselves.
Q. This is a store card that the small restaurant in Tottenham is operating without any opportunity of obtaining interest payments. You don't take interest into account yet again in this analysis.
A. That is correct. So you look -- for this approach, the Rochet and Wright approach, you look at the costs that the merchant would have to incur to provide the credit. Now, yes, of course, merchants also can earn credit -- interest revenue on it and somehow one would -- one might have to take that into account perhaps, although I would also think that the logic in Rochet and Wright most of the time is that when merchants provide credit it is not that they are a bank, they are in the business of lending, they do that to promote spending in their store, so I think even most store cards are probably more charge cards or transactional benefits orientated then actually being a source of profit. But that I have no further information on.

Q. You have no information, as we established yesterday, on the magnitude of the benefits that you say accrue to merchants, you haven't done any calculations that would give us an indication of the magnitude.
A. Correct. In this context we are talking about the costs to merchants of the alternative payment system. So in this context it wouldn't be relevant to quantify the benefits to merchants.
Q. You have calculated the costs to merchants, but the whole point of article 101(3) is to measure the benefits.
So what are the benefits you say that accrue to merchants?
A. Merchants obtain benefit from extending credit, both merchants individually --
Q. Sorry Dr Niels, we are talking about increased sales again are we?
A. Yes, increased sales. Both individually and in aggregate merchants benefit.
Q. And you haven't calculated at all the nature of the increased sales?
A. I have analysed the nature and I have explained the theory on extended -- so the effect on aggregate sales and I conclude that there is a positive effect. What I haven't been able to do and I think no one would ever

be able to do is quantify the exact benefits to merchants.
Q. Can I just ask one last question on exemption Dr Niels. It is quite an important question. Not that any of the others haven't been important, but this is an important question. Mr von Hinten-Reed has put forward an exemption methodology, which broadly follows Commission, correct?
A. He has put forward a methodology which broadly follows the Commission, correct.
Q. And you have put forward two methodologies, one is an issuer's based methodology, and the other is this adjusted MIT-MIF?
A. Yes.
Q. And you know that in the last hour or so of cross-examination that we have issues with your methodology, correct?
A. Yes.
Q. You know that the burden of proof is on MasterCard to prove an exemption, correct?
A. Yes.
Q. So my question is this: is the calculation that Mr von Hinten-Reed has undertaken one that is within a range in your view that the Tribunal could adopt sufficient to give MasterCard an exemption? If you want

me to repeat that I will, but essentially what I'm asking you is, I know you have your two methodologies, but is Mr von Hinten-Reed's methodology within a range in your view that the Tribunal could adopt sufficient to give MasterCard an exemption?
A. My answer to that is no. My adjusted MIT methodology is in essence the same as Mr von Hinten-Reed's MIT methodology, so if Mr von Hinten-Reed's methodology is accepted as a good approach for exemptible level, then in my opinion so should my adjusted MIT, it is just the adjustments that I make to my MIT approach are better founded in economic theory and economic principles. So it is still a MIT, I agree that it is still a MIT approach, but it has better foundations in economic theory, it is based -- so Mr von Hinten-Reed's approach is based on the very narrow interpretation of Rochet and Tirole. I think we have seen evidence already that even in Rochet and Tirole there are some doubts expressed about is that the right MIF or should you get a higher one, but there are five adjustments in later theoretical papers that express some doubts about that very narrow interpretation. The first one is that when assessing welfare do you also look at issuer profits or not? Rochet and Tirole themselves said it. Whether that applies to article 101(3), I don't know.

But the other four adjustments are -- and they all mean that if the narrow interpretation of MIT-MIF is too low, so all these adjustments would raise it, one is the fact that if, as Tirole in a later paper recognised, other payment systems, like cash, are also subsidised from a social perspective, so the consumer doesn't face the cost of -- the real cost of cash, then the MIT-MIF is too low.

Thirdly, if -- so the MIT-MIF in the narrow interpretation doesn't recognise the credit functionality, so that is the Rochet and Wright adjustment that I have also adopted.

Fourthly, in the Rysman and Wright paper we saw that there is concern that the MIT-MIF should -- so the interpretation of Rochet and Tirole of cost should be longer marginal costs so including fixed costs, so that you get the right long-term incentives between payment systems.

And the last adjustment, also in Rysman and Wright's paper, is that it is not just cash that is the comparator, you should also look at other comparators, in particular for online and that's also an adjustment I have made.

So in sum I would say we have tried to follow -- both the experts have tried to follow the MIT-MIF

approach, but I have said why I prefer my adjustment to it.
MR BREALEY: I'm moving on to a different subject, which relates to Amex and internal documents relating to Sainsbury's.
MR JUSTICE BARLING: How do you feel about the possibility of framing questions and answers sensibly -- I mean can it be sensibly done or is it really too difficult in view of the material to do it in public, without revealing the material?
MR BREALEY: I will try. Can I just ask Mr Hoskins: E13, tab 249, is that confidential? That's one of Mr Hoskins'. E13, tab 249?
MR HOSKINS: It is currently marked confidential.
MR BREALEY: I'm going to go to essentially page 531 ...
MR JUSTICE BARLING: If you think there is a significant risk that it is just going to be too difficult for the witness --
MR BREALEY: Actually it is the negotiation between Sainsbury's and Amex.
MR JUSTICE BARLING: So it is sensitive material.
MR BREALEY: It is really.
MR JUSTICE BARLING: The sort of questions you want to raise probably require --
MR BREALEY: I could just let Dr Niels look at them but --

MR JUSTICE BARLING: It sounds as though it is going to be too difficult. I think rather than waste time.
MR BREALEY: I will tell you what I could do, I could take the cross-examination a bit out of order.
MR JUSTICE BARLING: Well I'm a bit reluctant for you to do that ...
MR BREALEY: Why don't I do that and then it may be the afternoon will be in private because then I have to deal with Maestro, which is confidential. So if I was to do the Amex/Sainsbury's and the Maestro this afternoon and --
MR JUSTICE BARLING: If you think you can do it like that without, as it were, totally dislocating your --
MR BREALEY: It is a bit better than yesterday when I got to page 7 and I realised I didn't have about five pages of my cross-examination notes. But I found them.
MR JUSTICE BARLING: All right.
MR BREALEY: Okay, Dr Niels. Do you want to put everything away and then we will go on to something new.
Do you want to take bundle E1 out. Before we get to the documents, I know you are experienced in these matters, can you explain to the Tribunal what you understand by the concept of ancillary restraints?
A. I'm afraid I haven't got that really clear in my mind, it is a legal concept.

Q. I ask that because that is the basis upon which you give your economic evidence on the Visa counterfactual?
A. I can't say much more on that.
Q. Well let me show you some documents to assist you.
So when you have given your evidence on the Visa counterfactual and how there would be a migration from MasterCard to Visa, you haven't had regard to the concept of ancillary restraints?
A. Not as such, I have done my analysis in the context of knowing that counterfactual analysis is relevant for article 101(1) and 101(3) so I looked at various counterfactuals from an economic perspective. Where exactly it fits in the legal framework, in terms of ancillary restraint versus just generally agreements, I don't know. I didn't look at that specifically.
Q. But normally economists deal with ancillary restraints in mergers, don't they? They look at whether the overall transaction is pro-competitive and they look at whether the restriction is necessary for it; that's essentially what it is, isn't it?
A. Yes, I'm just confused by the term "ancillary". We look at restraints and we look at their effects on competition, but whether something is ancillary or not, that's the bit I'm saying that I don't have so clear in my head.

Q. Okay. Let's just try and put your economic evidence in some proper context then. If we can go to E1, tab 2A. I won't labour this point but I will go to the guidelines and the Court of Justice.
At tab 2A you have the Commission's guidelines on 101(3), which you say that you have read, yes?
A. Yes.
Q. Then if you go to page 38A.5, paragraph 28, it is headed "Ancillary restraints".
A. Yes.
Q. So, this is the concept of ancillary restraints. Paragraph 18 sets out a framework analysing the impact of agreement and its individual restrictions on inter-brand competition and intra-brand competition:
"If on the basis of those principles it is concluded that the main transaction covered by the agreement is not restrictive of competition, it becomes relevant to examine whether individual restraints contained in the agreement are also compatible with article 81(1) because they are ancillary to the main non-restrictive transaction."
29:
"In community competition law the concept of ancillary restraints covers any alleged restriction of competition, which is directly related and necessary to

the implementation of a main non-restrictive transaction proportionate to it."

Just pausing there. The question we are looking at, so you know that our submission is that there are three anti-competitive vices. There is a restriction between the issuers, there is a floor, there is a high floor. So what we are having to do is work out whether those three restrictions of competition are necessary for the implementation of the main agreement, which is the payment card scheme.

It goes on:

"If an agreement in its main part, for instance a distribution agreement or a joint venture, does not have as its object or effect the restriction of competition, then restrictions which are directly related to and necessary for the implementation of that transaction also fall outside article 101(1). Those related restrictions are called ancillary restrictions. A restriction is directly related to the main transaction if it is subordinate to the implementation of that transaction and is inseparably linked to it. The test of necessity implies the restriction must be objectively ..."

And we will pick up on this word again when we see the court:

"The test for implementation must be objectively necessary for the implementation of the main transaction and be proportionate to it."

Then 30:

"The application of the ancillary restraints concept must be distinguished from the application of the defence under article 101(3) which relates to certain economic benefits produced by the restrictive agreements and which are balanced against the restrictive effects of the agreement. The application of the ancillary restraints concept does not involve any weighing of pro-competitive or anti-competitive effects. Such balancing is reserved for article 101(3)."

Now, I take it from your answer a moment ago that when you are dealing with the Visa counterfactual you have not had this in mind?

A. Well, my analysis is about MIF and the competitive effects on MIF in various counterfactuals and I think my analysis fits very well into the overall framework. What I haven't done explicitly is to say the overall agreement is the scheme and the MIF is the ancillary restriction. I think for my economic analysis, making that explicit wasn't necessary, I think my analysis would in any event be informative for the legal assessment.

Q. Okay. If you move on to what the Court of Justice said about this at tab 19, page 419. It is not just an exercise in law, Dr Niels, I promise you, but it is extremely important when it comes to the context of your economic evidence.

So, page 419, MasterCard and I imagine your clients, which were RBS, were appealing this concept of ancillary restraints to the General Court and ultimately to the main court, the CJEU, and the findings of the main court are at page 419, paragraph 89:

"It is apparent from the case law of the Court of Justice that if a given operation or activity is not covered by the prohibition laid down in article 101, owing to its neutrality or positive effect in terms of competition, a restriction of the commercial autonomy of one or more of the participants in the operation is not covered by that prohibition rule either if that restriction is objectively necessary to the implementation of the operation."

Now I ask you to remember the word "objectively" because it is quite important.

"Where it is not possible to dissociate such a restriction from the main operation or activity without jeopardising its existence and aims, it is necessary to examine the compatibility of that

restriction with article 81... 101... in conjunction with the compatibility of the main operation or activity, even though taken in isolation such a restriction may appear on the face of it to be covered by the prohibition."

91:

"Where it is a matter of determining whether an anti-competitive restriction ...

So again the three vices:

"... can escape the prohibition laid down in article 101(1), because it is ancillary to a main operation that it is not anti-competitive in nature, it is necessary to inquire whether that operation would be impossible to carry out in the absence of the restriction in question. Contrary to what the appellants..."

Which I understood to be your clients:

"... claim, the fact that their operation is simply more difficult to implement or even less profitable without the restriction concerned cannot be deemed to give that restriction the objective necessity required in order for it to be classified as ancillary. Such an interpretation would effectively extend that concept to restrictions which are not strictly indispensable in the implementation of the main agreement. Such an outcome would undermine the effectiveness of the prohibition laid down in article 1."

Then 92 and 93 are important, but in the time I will go quickly to 94:

"In ruling that only those restrictions which are necessary in order for the main operation to be able to function in any event may be regarded as falling within the scope of the theory of ancillary restrictions and the fact that the absence of the MIF may have adverse consequences for the function of the MasterCard system does not in itself mean that the MIF must be regarded as objectively necessary if it is still apparent from an examination of the MasterCard system in its economic and legal context that it is still capable of functioning without it. The General Court did not err in law."

Again, have you had regard to -- it is not just a question of economic evidence because essentially what you are stating in your report -- you say so in terms really -- you say that article 101 does not apply because the MIF is so important to the MasterCard scheme. It is essentially what you are saying in your report, yes?

A. Yes. For various reasons, I have arguments -- 101(1) -- one category of reasons is, is it a restriction in the

first place and I have arguments on: no, because it is bilaterals and it is not a restriction actually -- acquiring competition isn't even restricted by common cost law. But indeed also I try to relate my economic evidence to the concept of objective necessity and there I have drawn the distinction between the European situation, or EC situation, which refers to the intra-EEA MIFs and domestic MIFs in the UK, in the relevant claim period and there I have laid out my evidence as to why the MIF was, in my mind, objectively necessary in those counterfactuals depending on what the other schemes do in competition.

But in essence competition, or the MIF was objectively necessary -- although that is a legal concept -- it was necessary in my mind to allow MasterCard to remain competitive in this specific period in the UK that we have seen.

Q. So that is one of the questions you have been asked to address, whether it is objectively necessary, and that is essentially the doctrine of ancillary restraints, because what is being asked is whether it is objectively necessary for the operation of the main transaction. The court has said you have to look at whether it is impossible and that is a question of law to a certain extent, but this is the ambit of what we are talking

about, yes?

A. Yes.

Q. Now, you yourself just mentioned the word "objectively" necessary. What do you understand by the term "objectively"? You have applied it.

A. Again I can only apply it as an economist, but if I look at the evidence and my own analysis, we are talking here about the MasterCard MIF that was in place. In the counterfactual in which the MasterCard MIF was much lower, as low perhaps as the claimants put it, then I think -- my objective analysis shows that you get significant competitive dynamics in the intra-scheme competition market. Now, those dynamics do depend of course on what Visa does. I have clearly shown, I think objectively, that if Visa -- if it is only MasterCard that goes down to that level, Visa stays the same and Amex is still also there, then the MasterCard scheme could not compete effectively, or probably would cease to exist in that market and therefore -- that was my ground for concluding in that scenario it is objectively necessary.

There is also the other scenario of course, if Visa also goes down. I have also outlined that in my report. I think there it is less clear, I'm less clear overall how the legal tests would apply. To me economically it

is clear that in that scenario, if both MasterCard and Visa went down, they would still struggle against Amex, so I have modelled it and clearly a lot of the premium business would be lost to Amex. But whether at that stage you would say they would go completely out of business, that I'm not clear about.

Q. Again, just -- this may be a legal point but it governs the parameters of your economic evidence. When you are looking at a objective necessity, are you looking at objective necessity simply from the perspective of MasterCard or are you looking at it from the perspective of a four-party scheme?

A. I think --

Q. It is quite an important distinction.

A. Yes, I think my analysis -- so the empirical evidence I have looked at MasterCard and I used the Maestro example. But actually my logic applies to any four-party scheme -- not to three-party schemes because they don't need a MIF to compete, but any four-party scheme. Any individual four-party scheme that is in competition with other schemes, four-party or three-party, if that scheme was the only scheme that was forced to go far down with its MIF, it would not be able to compete, it would be competed out of the market. So, in that sense, my analysis would also, if you flip it,

apply to Visa if you flip it around and Visa were the only scheme to be forced to set its MIF lower.
Q. I'm pleased you said that because I think at last you agree with something the European Commission has said, which is, if you take bundle E3.10, which is the Commission's survey again, tab 202, and turn to paragraph 52, page 4307, you said that essentially your economic approach applies to both Visa and MasterCard. You see there at -- I think we saw this yesterday -- but paragraph 52, where you see:
"A restriction of competition may fall outside the scope of article 101, if it can be shown that it is objectively necessary for the existence of agreement~..."
And these are the important words:
"... of that type or that nature."
So a restriction of competition may fall outside the scope of 101 "if it can be shown that it is objectively necessary for the existence of an agreement of that type or nature", and that is what objective necessity is looking at, it is looking at whether a four-party scheme of that nature can exist without a MIF; do you accept that?
A. Yes, so I think in terms of the nature, I'm talking about four-party credit card schemes and then in the

specific context of the UK market over this claim period. We have seen it before but the Commission in a number of times refers then also to comparable payment card schemes in other member states and I don't think I have gone into a lot of detail on that but I think those payment card schemes are not good comparators for these purposes. They were all domestic debit card schemes with a monopoly acquiring business. So not really competing in the same sense with other payment card schemes as MasterCard and Visa were clearly in the claim period with each other and with Amex.
From that perspective, if the question is about agreements of that type or that nature, I think we are talking here about four-party credit card schemes in the UK, in the relevant period.
Q. With that in mind, that's your economic approach -- do you still have E1 open?
A. Yes.
Q. If you go to tab 3, which is the decision of the Office of Fair Trading. I think at the time you were involved in this and there are many references to the submissions of MMF, which is your client.
A. Yes.
Q. If go to page 224 of this document. Something that I showed Mr Perez and I will show you the transcript

a bit later on. So it is at E1 at 224. Tab 3. This is an argument that -- a similar argument that MasterCard seems to be making in the present case. Summary of the arguments made. So this is under the heading that the MMF MIF -- so the MMF is your client as I understand it -- the MMF MIF must be set by reference to competitive restraints. This is what your client was submitting:
"The OFT fails to recognise that freedom to set the MMF MIF ...(Reading to the words)... would put the scheme at a severe disadvantage."
Then somebody else argues that without this freedom competition would be distorted, and you get the OFT's response:
"In essence this argument suggests that the cost of additional features ...(Reading to the words)... the recovery of these costs is necessary."
Now this is important:
"On this basis otherwise unlawful conduct would become lawful ...(Reading to the words)... the recovery of the extraneous costs through the MMF MIF."
And I promise it will be the last case I will take you to, I will take you to the British Airways case, but have you -- we will see in a moment Mr Perez was aware of this as a reason for -- in other words MasterCard

can't say "I need a MIF to compete with Visa" and Visa can't then say "I need a MIF to compete with MasterCard" because it all becomes circular. Have you factored this in to your counterfactual in your report?
A. I have explicitly made or recognised or set out that there are the two alternative counterfactuals, one in which both Visa and MasterCard go down, one in which MasterCard goes down and Visa stays up. I'm aware of the arguments pro and against. I have set out my reasons why I would actually prefer the scenario where Visa stays up but those were my reasons. I have set out the implications of both scenarios in my report. I think it is ultimately -- I think it is up here for the Tribunal to come to a view which of those scenarios are more relevant for the objective necessity questions but equally I would say later on for the damages question.
Q. I promise it will be the last case. If you quickly go to the authorities bundle, which is the British Airways case. It looks as if it is 12.2, but it is I2.2. It just looks as 12.2. It is the very first tab, tab 8A. I'm just showing you the passage that the OFT relied on. It is not just the OFT's view it is relying on established jurisprudence from the European Court.
I will give you the paragraph number. It is

paragraph 70. The page number is 1499A.23.
So here there was a complaint, British Airways were saying: you are only getting me, what about the others? And the General Court says:
"Whereas in this case the Commission is faced with a situation where numerous factors give rise to a suspicion of anti-competitive conduct on the part of several large undertakings in the same economic sector, the Commission is even entitled to concentrate its efforts on one of the undertakings concerned while inviting the economic operators which have allegedly suffered damage as a result of the possibly anti-competitive conduct of the other undertakings to bring the matter before the national authorities."
So, again, there in a counterfactual you have a situation where if somebody else is acting in the same way, they can be sued in damages. Were you aware of -- Mr Perez was aware of this principle; were you aware of this principle when you did your first report?
A. Sorry, of the principle about a damages claim?
Q. Yes, that in other words when you are asking yourself the question whether Visa would accept the issuers, you are asking yourself the question whether issuers would apply to be licensees of Visa, whether you accept that the retailers would just sit back and do nothing, there

are claims for damages against Visa if they are acting in the same anti-competitive way as MasterCard and I just am asking you whether you have factored into your counterfactual, which is a straight line migration down, whether you have factored in this possibility of some sort of check on Visa acquiring all this business because of a claim for damages?
A. Again, I have set out both scenarios. I'm aware of the reasons why you are in one rather than the other. The British Airways -- I'm aware of this principle, that if one breaks the law and the other doesn't because the other one does it, yes, that is an interesting principle to think about in this case. I think now the question is about the possibility that when thinking about let's say in the situation where MasterCard was forced to lower its MIF, whether Visa, rather than being forced by that same intervention or the same regulator, whether they would do so on the commercial basis or for fear of a damages claim later. I think I have considered it and I think it is actually one of the reasons why I -- for the damages case certainly, for the damages counterfactual, why I think that is unlikely, or rather the other way round, why I think it is likely that even in the relevant claim period, why if MasterCard had gone down in that period, Visa would not by itself have gone

down for fear of a damages claim or commercial consideration, because what we have actually observed -- and that's why I think the UK Maestro is such a good comparator market in the same period -- there are differentials between MIFs and that's beneficial to the scheme that can put the higher MIF. I mean that's the essence of competition between schemes, that actually if they have a higher MIF they can benefit.
So I think it would be -- it would have been speculative of me to say, well, Visa would have gone down just because they were facing a damages claim where I think commercially it would have been quite attractive for them to stay at a high level.
Q. You don't think then that the possibility of a damages claim, the fact that Visa is being investigated, the fact as we established with Mr Perez, the Commission saying both schemes could be treated equally, what you have just said a few moments ago that what applies to MasterCard applies to Visa, you don't think that would have any check on the migration at all?
A. I can only comment on what my impressions are but my impressions are that that whole period, the period that we are talking about was a very murky period with lots of uncertainty over what would happen and indeed what would be ultimately acceptable level of MIFs. In that

period of uncertainty, I can't see -- schemes would change if they were forced to by regulators and if there was more certainty and indeed we are now in a new world with regulations so it is all clearer, so it is a separate world, but in those nine years of the damages claim period that we are talking about, I think it was a murky period in which it was quite unclear where -- even what was the right level of MIF, domestic MIF, and where each scheme would have ended up. But that's just my impression, I can't give an expert opinion on that.
Q. No, precisely.
Can we just go to J2 and we will try and finish this before lunch.
I want to go to two more bundles. J2-bundle and D3.1. Your second supplemental report at D3.1. Tab 6.
So at tab 9 of J2, we have the evidence of Mr Perez and I will take this quickly because you have essentially agreed with what he has said.
But in page 17 of the transcript, 1120, at the top, his evidence is that the two four-party schemes are similar. So:
"Question: In this case, are you aware that MasterCard was arguing that the Visa exemption should apply to its methodology?
"Answer: Yes.

"Question: Why should the Visa methodology apply to MasterCard?

"Answer: Because ... based on cost and therefore similar."

I tried to get out of him "very similar", but he just maintained "similar".

If you go to page 18 over the page. Again, it is a pretty obvious fact. I ask:

"Question: What about just the mechanics of it? Four-party schemes; do you at least accept that they operate in a similar way --

"Answer: Yes."

We go on to page 38, which is where I asked him about a note of a meeting, so his 1141, page 38. There was a meeting between him and others and the Commissioner, where the Commission said there would be no discrimination against MasterCard and Visa.

I asked him about this principle of damages and he was aware of it. So I'm just setting the scene at the moment. I think you have accepted everything --
A. Yes.
Q. -- in your own evidence so far.

But then I would like to go to page 54. It starts at 54 but the relevant bit is at 56, 57. If I give you the context. At 54 I'm asking Mr Perez why he reduced

the -- (Pause).
MR HOSKINS: This bit was this camera.
MR BREALEY: This bit was, not the fact that they were similar. That is public knowledge, so thank you, but -- okay. Anyway, so I'm asking him -- this is what the CMA said, that they had reduced rates in November 2014, 2015.

Then if you go to page 56, I'm asking him why MasterCard did this -- I am grateful but it is a matter of public knowledge, CMA website, that MasterCard reduced its rates. And I'm asking why they did this.

(aside) Do you know whether 56, line 19 is confidential? It is. So I won't read that out. It was in camera.

I think I can mention a word, I would ask you to note the word "perception".
A. Sorry where?
Q. I'm sorry Dr Niels, it is page 1159, page 56, line 19.
A. Yes.
Q. So at line 19 it starts?

"Answer: "So the issuers ..."

Yes? Then it goes on. Then you get "the perception".
A. Yes.
Q. That is one of the reasons that he is saying that they

reduced. Then over the page at 57 I say:

"Question: "So the greater ... the less risk".

You see that?
A. Yes.
Q.

"Question: That would apply ..."

At 12, as well as to ... And he says ...

Okay?
A. Yes.
MR BREALEY: I'm finding it a bit difficult, but --
MR JUSTICE BARLING: If there's going to be much of this --
MR BREALEY: No there isn't. I would ask you to bear that in mind and then just go to the last document and then ...

So that was his evidence and if you go to your second supplemental report at page 621, this is in the section 4, the competitive dynamics. This is where you try and deal with Mr von Hinten-Reed's Australian experience. So this is dealing with Australia. You obviously know this?
A. Yes.
Q. One of the questions is, why did Amex not get a greater market share, yes?
A. Yes.
Q. Bearing in mind what Mr Perez says, at 4.16, this is

paragraph 4.16, 621. This is your own view as to why Amex did not obtain a greater market share and you say:

"I consider that the constant threat of being designated could have affected Amex's incentives such that it did not pursue a strategy to increase its market share considerably in Australia, as being designated would have led to its charges being capped in a similar way to MasterCard and Visa. There was no equivalent threat of a regulation of Amex in the UK during the claim period."

But what you are saying here is that the threat of being designated does affect the card payments incentives to pursue a strategy to increase market share and I would suggest to you that that is a commonsense view and one that equally applies to the Visa counterfactual -- see what we have just seen -- and that you should have factored this in to your Visa scenario 1 counterfactual.
A. Well, if I may comment on what the various bits that we have just seen?
Q. Of course.
A. Also from what Mr Perez was saying.

The way I see it and I'm simplifying perhaps but what I said earlier, the relevant claim period here was a murky world. So, yes, the Commission may have been saying "We will treat you both the same", but still that was -- even that wasn't clear whether they actually did but it was intra-EEA MIF. For domestic MIF in the UK there was no -- it wasn't clear what was going to happen, what would be the right level and we had the UK Maestro example. That was for most of the claim period. We are now in the new world of regulation, where it is much clearer, they are all going to be treated the same including Amex, in as far as it uses issuers.

So this current world is a different world and I understand Mr Perez's evidence is that yes a few things are happening in anticipation of the current world but it is still with the current world with regulation. The Australian example -- and again there are various interesting aspects of that Australian example and also why it is different from the UK example, but in Australia we are talking here there was a regulation in place and there was a mechanism whereby the authorities constantly kept an eye on Amex and I would say in response to the proposition that that was of a different nature because there was already a regulation from say Visa fearing that it would be treated, or its interchange fees would have to stay the same as MasterCard, even if the competition authority intervention were only against MasterCard. So I think

you can't entirely compare the two.

MR JUSTICE BARLING: Is that a good time?

MR BREALEY: It is.

MR JUSTICE BARLING: We are still on target?

MR BREALEY: We are still on target and we will be in camera --

MR JUSTICE BARLING: For the sake of those in court now, the likelihood is you are going to ask to be in camera more or less straight --

MR BREALEY: I'm doing the Amex and then the Maestro and all that is --

MR JUSTICE BARLING: All that is in camera. So most of the afternoon will be in camera?

MR BREALEY: That's what I'm thinking.

MR JUSTICE BARLING: Right. See you at 2 o'clock.

(1.00 pm)

(End of open session)

(The short adjournment)

(2.00 pm)

(REDACTED CONFIDENTIAL SESSION)

(4.00 pm)

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