Market review into the supply of card-acquiring services

Consultation on the approach to the profitability analysis

July 2019

MR18/1.6

We welcome your views on this consultation document. If you would like to provide comments, please send these to us by **5pm on 1 August 2019**.

You can email your comments to **cards@psr.org.uk** or write to us at:

Card-acquiring market review team
Payment Systems Regulator
12 Endeavour Square
London
E20 1JN

We will consider your comments when developing the analysis covered in this consultation document.

We will generally seek to make all non-confidential responses to this consultation available for public inspection in full or in part.

We will not accept blanket claims of confidentiality, such as a standard confidentiality statement in an email message. If you wish to claim confidentiality over specific items in your response to the consultation, you must identify those specific items which you claim to be confidential, and explain the basis on which confidentiality is sought. If you include extensive tracts of confidential information in your response, we will ask you to submit a non-confidential version.
We may nonetheless be required to disclose information marked as confidential in order to meet our legal obligations. This would be the case, for example, if we are asked to disclose confidential information under the Freedom of Information Act 2000. We will endeavour to consult you if we receive such a request under the Freedom of Information Act 2000. Any decision we make not to disclose information can be reviewed by the Information Commissioner and the Information Rights Tribunal.

You can download this consultation paper from our website:
www.psr.org.uk/psr-publications/consultations/mr1816-consultation-profitability-card-acquiring-services

We take our data protection responsibilities seriously and will process any personal data that you provide to us in accordance with the Data Protection Act 2018, the General Data Protection Regulation and our PSR Data Privacy Policy. For more information on how and why we process your personal data, and your rights in respect of the personal data that you provide to us, please see our website privacy policy, available here: https://www.psr.org.uk/privacy-notice

Contents

1 Introduction

1.1 The Payment Systems Regulator (PSR) is conducting a market review into the supply of card-acquiring services. The final Terms of Reference (ToR) were published on 24 January 2019.[1]

1.2 The purpose of this consultation is two-fold:

- to explain our proposed approach to assessing the profitability of card-acquiring services
- to invite comments on the proposed approach, in particular in relation to the questions set out in Chapter 4. In that chapter, we also explain how to respond to this consultation, and what the timeframe for responding is

Objectives

1.3 The aim of our market review is to consider whether the supply of card-acquiring services is working well for merchants (retailers or service providers), and ultimately consumers.

1.4 Profitability analysis can help us understand how competition is functioning.

1.5 Firms in a competitive market would generally earn no more than a 'normal' rate of profit – the minimum level of profits required to keep the factors of production in their current use in the long run. That is, the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity.[2]

1.6 In a competitive market, firms should not be able to sustain profits persistently above a 'normal' rate of profit over time. Therefore, profit above a 'normal' rate for a sustained period can be an indication that competition may not be working well in a market.[3]

1.7 Our profitability analysis aims to answer the following questions:

- How profitable is the supply of card-acquiring services generally?
- How does the profitability of card-acquiring services vary between acquirers?
- What do any variations in the profitability of card-acquiring services over time tell us about the way that acquirers reacted to the introduction of the Interchange Fee Regulation caps in December 2015?
- How does the profitability of card-acquiring services vary across broad types of merchant?
- How significant are other goods and services to acquirers' profitability?

1 Payment Systems Regulator MR18/1.2, *Market review into the supply of card-acquiring services – Final terms of reference* (January 2019).

2 CMA, *Guidelines for market investigations: their role, procedures, assessment and remedies (CC3)* (2013), paragraph 116.

3 CMA, *Guidelines for market investigations*, paragraph 118.

Our proposed approach

1.8 We propose to use two measures of profitability:

- return on capital employed (ROCE)
- gross profit margin (GPM)

1.9 There are advantages and disadvantages to both measures, regarding how well they reflect underlying economic factors. Therefore, it is beneficial to consider both. We expect to rely more on ROCE for the first two questions in paragraph 1.7 and more on GPM to address the second two questions. For the final question, we expect to rely more on revenue, gross profit and GPM. We discuss our choice of measures in Chapter 2.

1.10 For ROCE we intend to establish a range of plausible estimates, rather than precise values.

1.11 We intend to assess the profitability of the supply of card-acquiring services to UK merchants[4]. We propose to do this by comparing the profitability of acquirers to various benchmarks and by considering how profitability has varied over time. We propose to assess the five-year period from 2014 to 2018.

1.12 Providers of card-acquiring services often also provide other goods and services to merchants. These include point-of-sale (POS) terminals, payment gateways, cash advances and data analytics. We want to understand how significant these other goods and services are for the profitability of acquirers and how they impact on the profitability of card-acquiring services.

1.13 Our geographic scope is the supply of card-acquiring services to UK merchants. We recognise that some acquirers may not be able to easily distinguish revenue and costs relating to UK merchants from those relating to non-UK merchants. If this is the case, we will consider the extent to which we can draw meaningful conclusions about the profitability of the supply of card-acquiring services to UK merchants from larger data sets.

1.14 We intend to assess the profitability of the five largest acquirers supplying UK merchants with card-acquiring services, in the first instance. These acquirers accounted for approximately 90% of card transactions (by both value and number of transactions) acquired in 2018 at UK outlets.

1.15 The five-year period we have selected for our analysis straddles the introduction of interchange fee caps in the Interchange Fee Regulation in December 2015 and should therefore enable us to identify the effects of the change in interchange fee levels on costs, revenues and profitability.

1.16 We set out in the Annex the principles that we propose to require acquirers to follow in preparing their accounting data in response to our information requests (see also Chapter 3).

4 A UK merchant is any merchant with at least one UK outlet. An outlet is the location at which a transaction takes place. This could be, for example, the location of a shop. For an online transaction, this is generally the principal place of business of the merchant.

Our interpretation of the results

1.17 We recognise the challenges in conducting a profitability analysis. We will consider profitability in the context of our overall assessment[5] of whether the supply of card-acquiring services is working well for merchants, and ultimately consumers. We will consider this piece of evidence along with the other evidence that we gather. While useful, a finding that profitability is high in a market does not on its own provide conclusive evidence that the market is not working well for merchants and ultimately consumers.

Sharing our thinking and further development of our approach

1.18 This working paper sets out our current thinking on our approach. It does not make any judgement at this stage on the outcome of that analysis. We anticipate that our approach will be refined and updated as the analysis progresses, including to take account of responses to this working paper. As a consequence, the final analysis may depart significantly from what we set out here.

1.19 We will set out how the analysis has evolved in the interim report of our market review, including how we have taken into account comments on this working paper. The interim report will also set out preliminary results of the analysis.

1.20 The remainder of this document is structured as follows:

- Chapter 2 sets out the measures of profitability that we intend to use and how we will compare the results against benchmarks
- Chapter 3 sets out how acquirers and the PSR may need to adjust accounting data and the process that we will follow in gathering and analysing data
- Chapter 4 sets out our next steps and the questions that we invite comments on

5 CMA, *Guidelines for market investigations: their role, procedures, assessment and remedies (CC3)* (2013), paragraph 126.

2 Measuring profitability

2.1 In this chapter, we discuss the two measures of profitability that we propose to use (ROCE and GPM). We explain our choice of measures, how we will use them and how we will benchmark ROCE. We also discuss how we propose to assess the significance of other goods and services. Finally, we are interested in how acquirers themselves measure the profitability of card-acquiring services and the extent to which they use ROCE or other measures.

ROCE

2.2 We define ROCE as:

$$ROCE = \frac{Profit}{Capital\ Employed}$$

$Where$:

$Profit = \ EBIT\ (Earnings\ before\ interest\ and\ tax)$
$Capital\ Employed = Total\ assets\ less\ current\ liabilities$

2.3 ROCE is often the first choice of profitability measure used by competition authorities.[6,7] It has been widely used and is well understood.

2.4 ROCE has the advantage that it can be benchmarked[8] against the rate of return expected by investors in capital markets for investments of similar risk and capital structure. This expected rate of return is often referred to as the weighted average cost of capital (WACC).

2.5 ROCE relies on complete and accurate asset values for the capital employed component. However, the assets that are recorded in the accounts of acquirers may not reflect the complete set of assets that we will be interested in, from an economic perspective. In addition, valuations should be on an economic rather than accounting basis.

6 OFT and Oxera, *Assessing profitability in competition analysis* (2003), paragraph 1.30.
7 Although internal rate of return techniques are generally accepted as the most theoretically robust measures of profitability for use in competition policy, we have decided not to use these. This is because of practical difficulties in implementing them.
8 For a basic summary, see: OECD, *Policy Roundtables Excessive Pricing* (October 2011), pages 390 to 397.

2.6 Particular care is required with identifying and valuing intangible assets, including goodwill.[9] In the context of competition analysis, purchased goodwill may need to be excluded or reduced. A key issue with goodwill in this context is the potential for circularity.[10] Some intangible assets may not be recorded in the accounts of a business and may need to be recognised.

2.7 Calculations of ROCE for businesses that have relatively low levels of tangible assets can sometimes lead to results that appear high. However, our initial thinking is that ROCE is not prevented from being an adequate measure for such businesses. In practice, the asset value recorded in the financial statements of these businesses may appear low. One reason may be unrecognised or undervalued intangibles. One potential solution that we will consider is for acquirers to estimate a robust and evidence-based economic valuation for such intangibles, which we would review.

2.8 We propose to deal with completeness by asking acquirers to provide adjustments, supported by evidence, if they consider that there are unrecorded assets that should be included. Such evidence should be fully explained and justified. We will assess this evidence in the light of our approach and objectives, as well as the relevant guidelines and the approach set out in this document.

2.9 We propose to deal with valuation issues by requiring acquirers to estimate economic values for assets through adjustments[11], which should also be fully explained and justified and which we will review. We will interpret our results in the context of those adjustments.

2.10 Our starting point for the valuation of all assets will be the historic cost values reported by acquirers. We will consider proposals from acquirers for alternative valuations of capital employed from those contained in their financial records, including current cost valuations based on a modern equivalent asset basis (MEAV) and intangible assets. Acquirers will need to fully explain and justify such proposals, including providing supporting evidence and setting out their methodology.

2.11 We propose to use EBIT as the measure of profit in our ROCE calculation.

2.12 EBIT includes the returns to holders of debt as well as equity. Measuring profit before interest enables us to treat both types of capital employed consistently. We consider that an examination of the tax structures of the acquirers would introduce significant complications to the analysis while not providing additional information about whether competition or markets are working well. By measuring profit before tax, we will avoid this complication.

9 OFT and Oxera, *Assessing profitability in competition analysis* (2003), paragraph 5.24(b).
CMA, *Guidelines for market investigations: their role, procedures, assessment and remedies (CC3)* (2013), Annex A, paragraph 14.

10 OECD, *Policy Roundtables Excessive Pricing* (October 2011), page 395.

11 The typical types of adjustment are discussed in the following:
OECD, *Policy Roundtables Excessive Pricing* (October 2011), pages 394 to 396.
OFT and Oxera, *Assessing profitability in competition analysis* (2003), paragraphs 5.6 to 5.32.

2.13 Completeness and valuation issues also arise in the calculation of EBIT, which should be treated consistently with any adjustments made to assets. As with assets, we will review acquirers' submissions and acquirers will need to provide supporting evidence, explanations and justifications.

2.14 We intend to establish a range of plausible ROCE estimates, rather than precise values. Our assessment of this range will take into account the analysis used to derive it and the other analysis that we undertake as part of this market review.

2.15 Where we are making comparisons between acquirers, we will need the reporting of assets, revenues and costs to be on a consistent basis. We will issue guidance where necessary.

Benchmarking ROCE: the WACC

2.16 We propose to compare a pre-tax nominal ROCE with a pre-tax nominal WACC.

2.17 We will compare ROCE against a range of reasonable values for WACC.

2.18 We will establish such a range by drawing on relevant evidence. This will include adequately supported submissions from acquirers and recent regulatory decisions, such as those reported by the UK Regulators Network (UKRN).[12] We will also consider any submissions from parties other than acquirers. Although we appreciate that the regulated utilities covered by the UKRN reports differ from this sector, we will be able to review the standard parameters from these decisions, such as the risk-free rate and the equity market premium. The main component specific to card-acquiring services, that is likely to require estimation, will be the equity beta.

2.19 An alternative way of presenting the comparison of our ROCE results to a WACC benchmark, is to consider the implied capital base[13] that would be consistent with such a WACC benchmark. We propose to include this perspective in our analysis.

How we propose to use ROCE

2.20 We expect ROCE to be most useful in assessing the profitability of card-acquiring services and in comparing profitability between acquirers.

GPM

2.21 We define GPM as:

$$GPM = \frac{Revenue - Cost\ of\ Goods\ Sold}{Revenue}$$

$Where$:

$$Cost\ of\ Goods\ Sold = Direct\ selling\ costs\ and\ other\ relevant\ direct\ costs$$

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12 UKRN, *Cost of Capital – Annual Update Report* (June 2018), pages 9 and 10.

13 We will estimate this by applying 1/WACC to the reported EBIT. This gives the asset value to perpetuity implied by the capital markets. We will then compare this result to plausible estimates of the economic value of an acquirer's capital base.

2.22 GPM avoids much of the complication of the overhead and common cost allocations involved in calculating ROCE (although some direct costs, included in GPM, may be common to more than one product or business division too). In addition, it does not involve asset valuations or depreciation calculations.

2.23 There may be inconsistencies between acquirers in how they classify cost items and whether they include them in GPM. However, we propose to use ROCE as the primary tool for comparing between acquirers and to use GPM for studying patterns over time and across merchants, for the same acquirer. These comparisons should be unaffected by inconsistencies in cost classification between acquirers.

2.24 If we decide that it could be useful to use GPM for comparisons between acquirers, we would need to improve consistency in cost classifications. We could do this by providing guidance on cost classification. The principles that we set out in the Annex will also be helpful.

2.25 Since ROCE relies on profit after all costs, both direct and indirect, there are more variables that could change and influence the result. By contrast, GPM relies on gross profit, which will only be influenced by changes in direct costs. GPM is a simpler measure and therefore the cause and effect of changes in GPM may be more easily identified.

2.26 We are interested in the effects on GPM, if any, of changes in interchange fees following the introduction of the Interchange Fee Regulation. For this reason, as well as calculating GPM using gross revenue, we propose to also calculate it using gross revenue net of interchange fees.

How we propose to use GPM

2.27 We expect GPM to be most useful to us in identifying patterns in profitability: by type of merchant and over time.

2.28 Acquirers may define classifications of merchant differently, including by size, the sector that the merchant operates in and the type of contract offered. We may be able to derive additional insights from analysing between acquirers where definitions are sufficiently close to make such comparisons meaningful. We propose that acquirers provide granular information on their cost and revenue classifications.

Significance of other goods and services

2.29 To understand the profitability of card-acquiring services, we need to gather financial evidence about the profitability of other goods and services described in paragraph 1.12 above.

2.30 We will also consider the combined revenue, costs and profitability across card-acquiring services and other goods and services, to gain a more rounded view of a firm’s profitability.

2.31 The two primary measures that we propose to use in this assessment are revenue and gross profit.

3 Adjusting accounting data

3.1 As described in Chapters 1 and 2, accounting data needs to be converted into a form suitable for the calculation of our profitability measures. This chapter discusses these adjustments.

3.2 We first describe the changes to accounting data to reflect the scope of our analysis (scope adjustments), then the additional changes to reflect the economic substance of the activity (economic adjustments) and finally our proposed approach to data collection, which includes a set of principles.

3.3 We will require acquirers to make both sets of adjustments. They will need to provide supporting evidence, explanations and justifications, which we will review.

Scope adjustments

3.4 We defined the scope of our market review in the final ToR. In Chapter 1 of this document, under "*Our proposed approach*", we set out more specifically the extent of our profitability analysis.

3.5 The starting point for preparing the data that we require for our analysis may be the accounts of the legal entity, line of business, a sub-segment reported to management, or some combination of these. Acquirers should choose as their source, the most reliable and most suitable information available to them. In many cases, this is likely to be the management accounts for the most relevant part of the business. We will require these management accounts to be reconciled to the relevant set of audited financial statements for the five-year period.[14]

3.6 Whatever source is chosen, it may represent a larger part of each acquirer's business, than the scope of our analysis. In these instances, we would require acquirers to disaggregate the information to reflect the scope of our analysis.

3.7 Acquirers may need to disaggregate by:

- location (where activities in the UK and overseas are reported combined)
- the three broad product groups (card-acquiring services, card acceptance products and other goods and services)
- type of merchant (or, where material, by individual merchant)

14 All five acquirers have a year-end of 31 December. Therefore, there will be no need to adjust for different accounting periods.

3.8 Acquirers may also need to make adjustments. These may include:

- **Allocating revenue**: Where merchants pay one price for a package of goods and services that includes card-acquiring services, we would require acquirers to allocate the appropriate revenue to each of the products (or groups of products) that comprise the package, so as to match the costs that are identified for those products.
- **Allocating common costs and assets**: Common costs and assets (for example, corporate overheads and data centres) are shared across different products. We propose that acquirers allocate a suitable proportion of these costs and assets to card-acquiring services, card acceptance products and other goods and services. There are several different approaches that can be followed and acquirers will need to make a choice, based on our principles, the aim of the market review and the objectives in Chapter 1. Acquirers will need to fully explain and justify their choices, which will be subject to review.

Economic adjustments

3.9 We will consider adjustments to the accounting data to make it more relevant for the economic questions that we plan to consider.

3.10 The adjustments would likely include the following areas:

- The identification of assets that are not recorded in the financial records of the acquirers.
- The valuation[15] of both recorded and unrecorded assets on the basis of their economic value (for example goodwill). This would enable the determination of capital employed and related depreciation and amortisation charges.
- The spreading of costs between accounting periods and revenue categories to better reflect their economic utilisation.

3.11 We also recognise that acquirers may benefit from economies of scale and scope, regarding shared costs and assets. In other words, because of their size or because they have business activities outside card-acquiring services, their shared costs and assets may lead to lower costs and assets after allocation, compared to a stand-alone acquirer. We may therefore also consider estimates of costs and assets on a stand-alone basis, to provide additional calculations of the profitability measures.

3.12 We will require the acquirers (and interested third-parties may also make proposals, should they wish to) to provide these adjustments. Such adjustments should be supported and justified by objective evidence and robust economic arguments, which we will review.

15 For a discussion of such adjustments, see:
CMA, *Guidelines for market investigations: their role, procedures, assessment and remedies (CC3)* (2013), pages 88 to 90.

Our process

Principles

3.13 We propose to issue principles that acquirers will be required to follow in the preparation of their data, to ensure that the information that they provide is the most relevant, reliable and suitable for the purposes of our analysis. We set out our proposed principles in the Annex. Where acquirers depart from the principles and any guidance we set out, we will require them to highlight this and explain and justify the departure, which we will review.

Information request

3.14 We propose to gather initial data via one or more information requests using our formal information gathering powers. As explained above, acquirers will be free to choose the most suitable sources for providing such information. Sources are likely to include: management accounts, financial accounts and underlying data records.

3.15 We expect that much of the information would come from management accounts, as financial accounts may not provide sufficient granularity. Although this means that the information will not benefit from the external assurance that applies to financial accounts (management accounts are not audited), it may be more relevant for our purposes. Since management accounts are prepared to assist management in operating their business, they may lack some of the independence of financial accounts. Conversely, their relevance and quality for our purposes may be raised, due to the close interest that management express in them.

3.16 In addition, we propose that acquirers provide some further assurance by submitting reconciliations of all data provided to their audited financial statements.

Ensuring consistency

3.17 We will require acquirers to disclose and explain any changes over time to the basis of preparation of their underlying accounting data (for example changes in accounting policy) and the adjusted data that they are submitting. Where appropriate, we may require them to make adjustments to eliminate such inconsistencies and to disclose full details of these.

3.18 For some elements of our analysis, for example trends in profitability of an individual acquirer over time, consistency between acquirers may not matter. However, where we are making comparisons between acquirers, this will be important. In addition, where we are comparing the measures against external benchmarks, we will need consistency with the way that such benchmarks have been constructed. We will consider how to deal with any relevant inconsistencies identified. We may require acquirers to restate their numbers or we may make adjustments ourselves. However, we will also weigh the effort involved in making such adjustments against the materiality of the impact of such inconsistencies on our analysis.

4 Next steps

4.1 We welcome any comments on the proposed approach to the profitability analysis set out in this consultation document. Below are some questions we believe may be particularly important to receive comments on.

4.2 The questions are the following:

- Do we have the right objectives for our profitability analysis, given the aim of this market review?
- Have we selected suitable measures of profitability, given our objectives?
- Do stakeholders agree with our proposed approach to benchmarking and do they have views on how to establish a suitable range of values for comparison?
- Have we identified all the material types of adjustment to data?
- Will our proposed process be adequate to generate a reliable analysis, given our objectives?

4.3 Please send your comments to us by 5pm on 1 August 2019. You can email them to cards@psr.og.uk or write to us at the following address:

Card-acquiring market review team
Payment Systems Regulator
12 Endeavour Square
London
E20 1JN

Disclosure of information

4.4 Generally, we will seek to publish views or submissions in response to this consultation in full or in part. This reflects our duty to have regard to our regulatory principles, which include those in relation to:

- publication in appropriate cases
- exercising our functions as transparently as possible

4.5 We will not accept blanket claims of confidentiality. If you wish to claim confidentiality over specific items in your submission, you must identify those specific items which you claim to be confidential, and explain the basis on which confidentiality is sought. If you include extensive tracts of confidential information in your submissions, we will ask you to submit non-confidential versions.

4.6 We may nonetheless be required to disclose information marked as confidential in order to meet legal obligations. This would be the case, for example, if we are asked to disclose confidential information under the Freedom of Information Act 2000. We will endeavour to consult you if we receive such a request. Any decision we make not to disclose information can be reviewed by the Information Commissioner and the Information Rights Tribunal.

4.7 In accordance with the legal framework in the Financial Services (Banking Reform) Act 2013 (FSBRA), we will not disclose confidential information that relates to the business or affairs of any person, that we receive for the purposes of our functions under FSBRA, unless:

- we have the consent of the person who provided the information and, if different, the person to whom it relates, or
- there is a 'gateway' permitting such disclosure. One of the gateways is the 'self-help' gateway whereby the PSR will be able to disclose confidential information to third parties to enable or help the PSR to perform its public functions. Where we disclose confidential information to a third party, we may impose restrictions on the further disclosure or use of the information by such parties.

4.8 You should note that information that is already lawfully publicly available or in such a form that it is not possible to ascertain from it information relating to a particular person (for example, if it is summarised, anonymised or aggregated) is not confidential information for the purposes of FSBRA.

4.9 We take our data protection responsibilities seriously and will process any personal data that you provide to us in accordance with the Data Protection Act 2018, the General Data Protection Regulation and our PSR Data Privacy Policy. For more information on how and why we process your personal data, and your rights in respect of the personal data that you provide to us, please see our privacy policy on our website, available here: https://www.psr.org.uk/privacy-notice.

Annex
Principles for preparing data

We propose that acquirers should follow seven principles when preparing responses to our information requests. These principles should be followed in the order of priority set out below.

1. Completeness – all relevant revenue and costs are recognised through the profit and loss account and all relevant assets and liabilities are recorded in the balance sheet.
2. Objectivity – the basis of preparation and the allocation methodology for revenues, costs, assets and liabilities use a robust methodology that aims to provide a realistic representation of performance, assets and liabilities and does not favour a particular outcome or conclusion.
3. Consistency with the objectives of this analysis – the basis of preparation and the allocation methodology are consistent with the objectives of this market review and of this profitability analysis.
4. Causality – acquirers must ensure that:

a. costs (including costs resulting from transfer charges)

b. assets

c. liabilities

are attributed in accordance with the activities which cause the costs to be incurred, or assets to be acquired, or liabilities to be incurred respectively. This principle also applies to the disaggregation of aggregate reporting.

5. Revenue allocation – revenues are allocated based on the volumes and prices for individual products that underlie them. Where products are sold together and individual prices do not exist, firms may follow their existing methodology used in their reporting or propose a new methodology.
6. Consistency over time – the basis of preparation and of allocation of revenues, costs, assets and liabilities remain the same over time.
7. Transparency – the basis of preparation, the allocation methodologies and any assumptions used are clearly and fully explained and justified. Any deviations from these principles are justified and explained, including an assessment of the impact of such deviations.

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