Payment Systems Regulator

Market review into the supply of card-acquiring services: Interim report

Annex 3
Financial review

September 2020

MR18/1.7 Annex 3

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Note: The places in this document where confidential material has been redacted are marked with a [✂].

Introduction

1.1 Profitability analysis can help us understand how competition is functioning. Its usefulness depends on the availability of relevant and reliable financial information.

1.2 We did not carry out the more traditional profitability analysis that we had proposed at the start of the market review and whose methodology we consulted upon in July 2019.[1] (We explain the reasons for this at paragraphs 1.18 to 1.20 and 1.34 to 1.36). Instead, we carried out a financial review of the evolution over time of the MSC paid by merchants to the five largest acquirers and its components. The MSC is the total amount merchants pay to acquirers for card-acquiring services and comprises: interchange fees, scheme fees[2] and acquirer net revenue. Acquirer net revenue includes the costs the acquirer incurs (other than interchange fee and scheme fees) to provide card-acquiring services, plus the acquirer's margin.

1.3 This analysis provides additional information about some of the issues covered by the pass-through analysis (see Annex 2). In both cases, our observations include the five largest acquirers[3] and the same period of 2014 to 2018. However, there are important differences. For example, in the analysis set out in this annex, we assess the aggregate financial reporting of each acquirer, which includes all the activity that acquirer undertakes during the period. By contrast, the pass-through analysis uses data relating to a sample of merchants. The pass-through data was collected on a monthly basis, whereas the analysis in this annex uses annual data.

1.4 The value of the analysis set out in this annex is in describing the aggregate results and with an acquirer-centric view. The pass-through analysis is designed to assess whether acquirers passed through to merchants the cost savings they made from the Interchange Fee Regulation caps on interchange fees ('IFR caps'). The pass-through analysis focuses on merchants and follows a more granular approach, such as the use of monthly data. The pass-through analysis underpins our provisional findings. The results of the financial review presented here are consistent with our pass-through analysis.

1.5 This annex explains our original, intended methodology that we consulted upon. It then discusses the consultation responses and the data that we received. In light of this, it then sets out how and why we revised our approach. Finally, it summarises the main results of our analysis and our provisional findings.

1.6 This annex has three sections:

- approach to profitability analysis
- information requested and information received
- analysis and results

1 Payment Systems Regulator MR18/1.6, Market review into the supply of card-acquiring services – Consultation on the approach to the profitability analysis (July 2019).

2 We use the term 'scheme fees' to refer to all fees acquirers pay to operators of card payment systems including fees for scheme services and fees for processing services.

3 The five largest acquirers accounted for nearly 90% of transactions by number and value at UK merchants in 2018. See Annex 1 for a description of the five largest acquirers.

Approach to profitability analysis

Consultation on our proposed approach

1.7 We originally proposed to use two measures of profitability: return on capital employed (ROCE) and gross profit margin (GPM), to answer the following five 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 IFR caps on interchange fees 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?

1.8 We expected to rely more on ROCE for the first two questions above and more on GPM to address the second two questions. For the final question, we expected to rely more on revenue, gross profit and GPM.

1.9 We also expected to use ROCE for making comparisons between acquirers, whereas GPM would be more useful for identifying patterns in profitability by type of merchant and over time.

Respondents' views

1.10 We received nine responses from acquirers, Mastercard and others.[4] The main points raised related to: the use of ROCE, the use of GPM, interpretation of the results and extending the timeframe of the analysis. We briefly summarise each of these points in turn.

4 Payment Systems Regulator, MR18/1.6: *Responses to our proposed profitability analysis consultation* (December 2019).

Use of ROCE

1.11 Acquirers raised concerns about our proposed use of ROCE as a measure of profitability. These included:

- **The calculation of ROCE would be very complex and require a lot of resources to undertake.** The five largest said they did not use ROCE in their normal course of business. Most of them said that its calculation would represent a significant challenge. They provided several reasons for this.

  Firstly, it would require an allocation of common costs not currently done in the business. The five largest acquirers are part of groups that operate internationally or with significant non-acquiring activities (such as banking). These groups have large, shared support functions, such as IT platforms and customer service centres, with fixed and common costs that would need to be allocated to the UK business and to card-acquiring services. This would require agreement on the allocation methodology and the collection of any non-financial data needed to calculate the allocations.

  Secondly, intangible assets (such as customer bases, brands and know-how) would need to be valued to calculate an appropriate measure of capital employed. These would be difficult to identify and to value appropriately.

  Thirdly, calculating robust cost allocations over five years would be challenging, particularly for acquirers that have restructured (including because of mergers) or changed accounting systems or accounting periods during the period under consideration (2014 to 2018).

- **ROCE would be difficult to interpret, and of limited value in understanding the supply of card-acquiring services.** Uncertainty in the valuation of intangible assets and in the adjustments that would need to be made to accounting data to provide economically meaningful information, could lead to a wide range of plausible results for any one acquirer. The results would also not be comparable across acquirers, which have different business models and organisational structures, and this would make it difficult to draw clear conclusions. Acquirers argued that if we did not provide them with detailed guidance, the adjustments they would make would not be consistent. The definitions for earnings before interest and taxation (EBIT) also differ across the acquirers. (EBIT would be used to calculate profit for the numerator of the calculation).

1.12 Three acquirers noted that difficulties in the calculation of a robust ROCE have led the CMA to decide not to use it as a profitability measure in two recent market investigations and one market study. These were in sectors where similar issues arose to those summarised above. The sectors concerned were audit services, retail banking and investment consultants.

Use of GPM

1.13 Respondents also raised concerns in relation to the use of GPM. Acquirers considered that it would be hard to isolate the impact of the IFR caps on GPM because there were many other factors that could determine the development of GPM over time.[5] Therefore, it could be problematic to establish a causal link between changes in GPM and changes in interchange fees as a result of the IFR caps.

1.14 Respondents commented on several other factors that could limit the value of our GPM analysis:

- Scheme fee attribution to UK merchants may vary greatly between acquirers. Acquirers may attribute some of the fees to merchants but expense other fees as an overhead (and therefore not include them in GPM). A high degree of attribution may lead to a lower GPM and vice versa. [✂]
- GPM is likely to overstate profitability of card-acquiring services and other products because it does not take account of fixed and common costs, nor upfront investments (for example in IT platforms).
- Indirect costs may vary significantly between different merchant groups and this would not be reflected in a GPM analysis, if used to make comparisons of profitability between merchants.

Interpreting our results

1.15 Two respondents commented that profitability analysis must be viewed alongside other evidence, such as existing competition, potential competition, buyer power and changing market conditions.

1.16 Another respondent pointed out that a finding of high profitability does not conclusively demonstrate weak competition and that conversely, 'normal' returns do not necessarily mean that competition is working effectively.

Extending the time frame for our analysis

1.17 Two respondents said that interchange fees had already started reducing before the IFR caps came into force on 9 December 2015. They therefore argued that we should also consider years earlier than 2014 to understand the impact of changes in interchange fees.

5 Factors cited included changes in costs, changes in the volume and value of transactions acquired, investments, changes in market conditions and structural changes (for example, mergers)

Our response

1.18 Having considered the responses, and given the resources available and the overall market review timetable, we decided to proceed with the GPM analysis and not to proceed with ROCE. We considered that:

- GPM was likely to provide relevant insights for our overall assessment, particularly on how profits changed around the introduction of the IFR caps, how profits varied by merchant type, and how significant products other than card-acquiring services were for acquirers. We acknowledge the challenges in establishing causal links between changes in GPM and changes in the levels of interchange fees and scheme fees. There are many other factors that could influence the level of GPM, such as changes in costs (other than interchange fees and scheme fees) and other operating conditions. These factors may lead to prices and volumes changing and GPM varying as a result. Nevertheless, we believed that the results of the GPM analysis, taken in combination with the other evidence and analysis undertaken as part of this review, could provide insight and would be likely to help us reach our provisional findings. (Note that upon the receipt of limited cost information from acquirers, we subsequently adjusted our approach to being a financial review of MSC and its components. We discuss this further below in paragraphs 1.28 to 1.36).
- ROCE would incur significant costs to calculate in a consistent and robust way. Substantial adjustments to accounting data would be required. In particular, the valuation of intangible assets would require a large degree of judgement, which could lead to a range of possible values for an acquirer, as well as inconsistency between acquirers. Cost allocation methodologies would need to be developed and applied to each of the acquirers' cost bases, involving the use of non-financial data and assumptions (for example the allocation of corporate overheads). Even if the task of calculating a ROCE were carried out and the costs incurred, there was likely to be a wide range in outcomes, from a range of plausible assumptions and methodologies, which would involve significant judgement to be exercised for any firm conclusions to be drawn or robust comparisons between providers to be made.

1.19 In September 2019, we published an update on our proposed approach, explaining that we would focus on the GPM analysis.[6] This meant that we narrowed the set of five questions that the profitability analysis aimed to answer (see paragraph 1.7). In particular, we decided not to consider the first two questions. The GPM analysis would be used to address the remaining three questions relating to the impact of the IFR caps on profitability, variability in profitability between merchant types, and the significance of products other than card-acquiring services to acquirers' profitability.

1.20 Our decision to use only GPM also meant that we would shift our focus away from making comparisons between acquirers.

1.21 On the interpretation of the results of our profitability analysis, we agreed with respondents that our results should be considered alongside other evidence collected as part of the market review.

1.22 We decided not to extend the period of our analysis (five years from 2014 to 2018) to include data before 2014, on the basis that having almost two years' worth of data prior to the IFR caps coming into force would be sufficient to assess their impact.

6 Payment Systems Regulator, *PSR update on its approach to the profitability analysis for its market review into card-acquiring services* (September 2019).

Information requested and information received

Information requested

1.23 From each of the five largest acquirers, we requested annual revenues, costs and data on the volume – that is, number – and value of transactions acquired and the number of merchants served. These were analysed across three product types: card-acquiring services, card acceptance products and value-added services. For card-acquiring services, we requested a further breakdown of revenue by: MSC, interchange fees, scheme fees[7] and acquirer net revenue.

1.24 We also requested further 'segmental' breakdowns of acquirer net revenue data by merchant size and by pricing option.[8]

1.25 For the cost information, we only required acquirers to provide it, if they were already reporting it according to our scope and at the level of granularity that we required.

1.26 We also required acquirers to reconcile their information to their management accounts and in turn, their audited annual reports.

1.27 We did not require the production of new cost information, because we considered that agreeing, specifying and applying new cost attributions would involve an amount of time, cost and effort that would be disproportionate to the additional benefit to the analysis that might result.

Information received

1.28 The five largest acquirers provided us with the revenue information as required and the data we requested on the volume and value of transactions they acquired and the number of merchants served. However, they had difficulty providing cost information to us according to our required scope and level of granularity.

1.29 Since acquirers reported costs at a more aggregated level and we had not required acquirers to carry out additional cost attributions, acquirers did not provide the cost information that we required (although some were able to provide some elements of it). In their responses, acquirers explained why they had difficulty attributing costs:

- **Geography**. Acquirers had difficulty identifying costs relating to UK activities and, in particular, to our definition of UK merchant (which also included the non-UK outlets of such merchants).

7 Any scheme fees giving rise to fees for an acquirer's merchants were to be included (not just Mastercard and Visa scheme fees).

8 In the information request, we referred to 'tariff type'.

- **Product**. Acquirers found it difficult to separate the costs of card-acquiring services from other products. In some cases, acquirers had difficulty separating the costs of the acquiring business as a whole, from the costs of the other businesses within their corporate groups.
- **Large central overheads.** A large proportion of costs were incurred at group level (such as IT platforms and customer service centres) and were not allocated to individual services or customers.

1.30 Regarding geography and conforming to our scope of UK merchants, we considered using the UK businesses or the European businesses of the acquirers, as proxies for UK merchants. However, this would have introduced some inaccuracies, as well as requiring a further round of data collection, which we did not consider proportionate given our timetable.

1.31 Regarding identifying product level costs and attributing central overheads, we considered using transfer charges or information contained within statutory accounts.

1.32 Transfer charges could not be used to derive costs because they typically were raised at a company or management reporting level and not at a product level.

1.33 Statutory accounts did not provide a suitable alternative source of cost information either. In most cases, the activities of the legal entity did not closely match our scope. For some acquirers ([✂]) the legal entity serving UK merchants provided support to other parts of their group, in other countries. This meant that their UK statutory accounts contained a mix of costs related to both UK and non-UK activity. Also, for some acquirers ([✂])[9] the statutory reporting entity was at a group level, rather than at the level of the acquiring business. [✂]

1.34 Because of the limited cost information that acquirers provided, it was not possible to undertake a GPM analysis that would have been meaningful.

1.35 Since a traditional profitability analysis was not possible, given the high costs involved in collecting suitable cost information compared to the likely benefits, we decided to carry out a financial review of acquirer net revenue. Trends in acquirer net revenue could inform our understanding of how the IFR caps affected the evolution of the relationship between interchange fees and MSC, over time. For the remainder of this annex, we therefore discuss our preliminary findings on acquirer net revenue.

1.36 Finally, we note that some acquirers reported significant differences in the reconciliations of their results to their management accounts and to their annual reports. In some cases, we were not satisfied with the explanations provided. However, we were unable to pursue these explanations further, given the timetable of our market review.

9 [✂]

Analysis and results

Introduction

1.37 As explained above, following consultation, the revised purpose of our analysis was to address the following four questions and we consider each of these in turn below:

- What do any variations in acquirer net revenue over time tell us about the way that acquirers reacted to the introduction of the IFR caps in December 2015?
- How does acquirer net revenue vary across broad types of merchants?
- How significant are other goods and services to acquirers' revenues?
- Does the cost information provided indicate that acquirers were making investments to enhance quality of service?

1.38 For the reasons set out above, based on the information that we received, we re-focused our analysis onto a financial review of acquirer net revenues, rather than considering profitability and GPM.

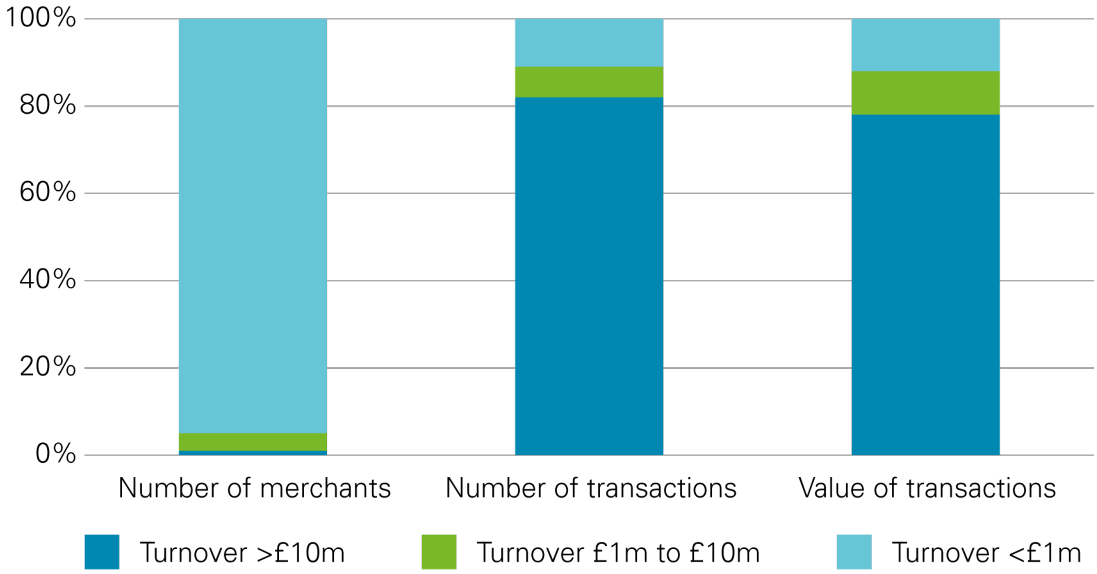
1.39 Since we are considering acquirer net revenue, which is before the deduction of costs (other than interchange fees and scheme fees), we are unable to conclude on profitability. However, we can look at the trends over time of acquirer net revenue, the variability of acquirer net revenue by merchant type and the contribution that card acceptance products and value-added services make to overall acquirer revenues. The first two of these, in particular, may give some insight to acquirers' pricing behaviours.

1.40 Our analysis totals the data across all of the five largest acquirers, in each year[10], and divides by the card turnover of these acquirers in each year. The result, as well as being an aggregate of all the five largest acquirers, is effectively a weighted average, weighted by annual card turnover.

1.41 As shown in Figure 1 below, the large proportion of transactions accepted by large merchants (both by transaction value and number of transactions), means that the overall results of our financial review are driven primarily by the results for large merchants with annual card turnover above £10 million. The results for small and medium-sized merchants may be different but may be obscured at the aggregate level of our analysis. However, acquirers have also provided some segmentation of their results by merchant size, giving us the potential to see results for small and medium-sized merchants more clearly. We discuss this in paragraph 1.52.

10 Four of the acquirers had financial reporting periods that coincided with the calendar year. However, Global Payments did not, reporting to 31 May 2014, 2015 and 2016 and thereafter to 31 December 2017 and 2018 (with a seven-month bridging period between 31 May 2016 and 31 December 2016). In our analysis, for the calendar years 2014 to 2016, we took the results of the financial year ended 31 May, whereas for 2017 and 2018 the reporting and calendar years coincided. We compared this approximation to a pro-rated approach and the choice did not materially affect the aggregated results for the five largest acquirers.

Figure 1: Distribution of merchant size: average across four acquirers and between 2014 and 2018



Source: PSR analysis of data provided by four acquirers. The remaining acquirer used different size categories but showed a similar pattern.

1.42 Figure 1 shows that, overall, for the five largest acquirers, large merchants account for approximately 80% of card transactions by both value and number of transactions. However, those merchants only represent 1% of the total number of UK merchants served by the five largest acquirers.

1.43 This pattern is also broadly consistent with the distribution of the business population of the UK economy.[11]

Variation in acquirer net revenue over time

1.44 Our analysis examines the variation, over time, of the elements that comprise the MSC – being interchange fees, scheme fees and acquirer net revenue.

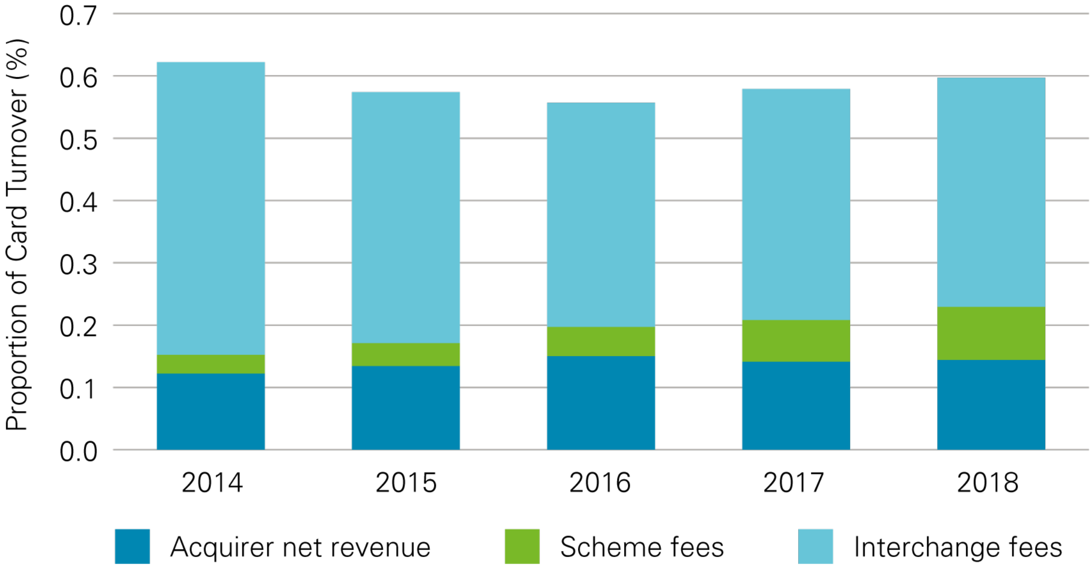
1.45 Figure 2 below shows interchange fees, scheme fees[12], and acquirer net revenues. Results are expressed as a percentage of card turnover, being a weighted average of the five largest acquirers, over the period 2014 to 2018. We look at changes mainly over two periods, both of two years' duration: 2014 to 2016 and 2016 to 2018. As explained above, the data that we collected was annual data, generating an average for each calendar year.[13] Table 1 shows the data that Figure 2 is based upon. Table 2 shows the percentage changes in the MSC and its components over time. Table 3 shows the shares of the different components of the MSC over time.

11 Department for Business, Energy & Industrial Strategy, *Business population estimates for the UK and regions 2018: detailed tables* (October 2018).

12 Figure 2 shows scheme fees for all four-party card payment systems. The vast majority of these are Mastercard and Visa fees.

13 When looking at time intervals between the years, the annual data can be thought of as being mid-year. Therefore, for example, the period between the 2014 and 2016 data is two years, running from mid-2014 to mid-2016.

Figure 2: Average MSC as a percentage of card turnover split by interchange fees, scheme fees and acquirer net revenue.



Source: PSR analysis of data provided by the five largest acquirers. Weighted average of the five largest acquirers (weighted by card turnover) expressed as a percentage of card turnover from 2014 to 2018.

Table 1: Weighted average MSC and its components: amounts

	Proportion of card turnover (%)				
	2014	2015	2016	2017	2018
Interchange fees	[✂]	[✂]	[✂]	[✂]	[✂]
Scheme fees	[✂]	[✂]	[✂]	[✂]	[✂]
Acquirer net revenue	[✂]	[✂]	[✂]	[✂]	[✂]
MSC	[✂]	[✂]	[✂]	[✂]	[✂]

Source: PSR analysis of data provided by the five largest acquirers. All results are displayed to three decimal places although calculated using more decimals. Owing to rounding, calculations based on the numbers displayed may vary slightly from the results shown.

Table 2: Weighted average MSC and its components: changes

	Change between years					
	Δ 2014-18	%Δ 2014-18	Δ 2014-16	%Δ 2014-16	Δ 2016-18	%Δ 2016-18
Interchange fees	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Scheme fees	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Acquirer net revenue	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
MSC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: PSR analysis of data provided by the five largest acquirers. All results are displayed to three decimal places although calculated using more decimals. Owing to rounding, calculations based on the numbers displayed may vary slightly from the results shown.

Table 3: Weighted average MSC and its components: shares

	Share of MSC (%)				
	2014	2015	2016	2017	2018
Interchange fees	[✂]	[✂]	[✂]	[✂]	[✂]
Scheme fees	[✂]	[✂]	[✂]	[✂]	[✂]
Acquirer net revenue	[✂]	[✂]	[✂]	[✂]	[✂]
MSC	[✂]	[✂]	[✂]	[✂]	[✂]

Source: PSR analysis of data provided by the five largest acquirers. All results are displayed to three decimal places although calculated using more decimals. Owing to rounding, calculations based on the numbers displayed may vary slightly from the results shown.

1.46 Figure 2 shows that[14]:

- **Average interchange fees** fell significantly between 2014 and 2016 by [✂]% and then remained approximately constant.[15] Approximately half of this reduction happened between 2014 and 2015 and the remaining half between 2015 and 2016.
- **Average scheme fees** more than doubled over the period from 2014 to 2018 (rising by [✂]%), with most of this increase occurring between 2016 and 2018, after the introduction of the IFR caps. Scheme fees made up a significantly smaller proportion of the MSC than interchange fees, over the period between 2014 and 2018. However, during that period, the share of the MSC relating to scheme fees rose, whereas the share relating to interchange fees reduced. This means that while the effect of scheme fee increases on the MSC is likely to be less significant than changes in interchange fees, it isn't negligible.
- **Average MSC** fell by [✂]% as interchange fees fell between 2014 and 2016. However, the decrease in the average MSC is less than the decrease we observe in interchange fees, resulting in a higher acquirer net revenue. After 2016, the MSC increases by [✂]%, mainly driven by a rise in scheme fees.
- **Average acquirer net revenue** rose between 2014 and 2016 by [✂]%, then flattened off. This shows that acquirers increased their net revenue at the same time as interchange fees fell.

1.47 We observe that average interchange fees fell [✂] between 2014 and 2015 – prior to the introduction of the IFR caps. This is due to changes Mastercard and Visa made to their interchange fee rates over the course of 2015, including those made by Visa as part of the Cross-Border Domestic Interchange Programme (CBDIP) that took effect on 1 January 2015.[16] Visa introduced the CBDIP following commitments and undertakings given in the context of competition law investigations carried out by the European Commission. The CBDIP enabled cross-border acquirers to elect between either the domestic debit or credit interchange fee rate applicable to a transaction or an interchange fee rate of 0.2% or 0.3% – for debit and credit cards respectively – provided certain conditions were met. The CBDIP meant that acquirers were able to lower the interchange fees they paid for certain transactions in countries that had higher domestic debit or credit interchange fee rates. In practice, the applicable conditions meant that the CBDIP was most likely to apply to transactions involving large merchants, for example because only transactions involving merchants with IC++ pricing could qualify.

1.48 We further observe that interchange fees fell from [✂] to [✂] between 2015 and 2016, following the IFR caps coming into force in December 2015.

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14 Two acquirers ([✂]) reported significant activity at their non-UK outlets and these are included in our analysis. Exclusion of these non-UK outlets from the analysis generated results showing the same trends but they were more marked.

The results presented are a weighted average of the five largest acquirers. Two acquirers ([✂]) had individual results that showed a significantly different pattern from the average. In both cases, their size and contribution to the total across the five largest acquirers, was not sufficient to significantly distort the average trend presented. [✂]

15 We observe average IFs remaining above the level of the caps because the data includes transactions involving commercial cards and cards where the issuer was located outside the EEA, which were not capped by the IFR.

16 Other relevant changes Mastercard and Visa made to their interchange fee rates during 2015 are described in Annex 2.

1.49 Over the two-year period between 2014 and 2016, interchange fees have fallen significantly. We observe this both in our financial review and in our pass-through analysis (see Figure 2 in Annex 2).

1.50 However, the pattern of reductions during the two-year period differs between the two analyses. As explained above, our financial review shows two significant reductions of similar size, with the larger one being between 2014 and 2015. By contrast, the pass-through analysis shows most of the reduction happening towards the end of the two-year period, when the IFR caps came into force. The reason for this difference is that the two analyses take different approaches and use different data sets. Importantly, for our pass-through analysis, the approach to sampling was designed to result in a random sample in which each merchant has an equal probability of being entered into the sample so that the statistics illustrate the experience of typical merchants. In contrast, our financial review is dominated by large merchants and represents the total results of the five largest acquirers. Therefore, the effect of the CBDIP in reducing interchange fees for large merchants is visible between 2014 and 2015 in the financial review but not in the pass-through analysis.

1.51 We note that there could have been other factors that may have led MSC and acquirer net revenue to vary over the five years, including: changes to operating costs, changes in the volume and value of transactions acquired, changes in services and changes in the business environment.

Variation in MSC by type of merchant

MSC by merchant annual card turnover

1.52 When we analysed the trends in MSC over time, for merchants of different sizes, we found that there was no consistent pattern among acquirers. We were unable to examine this further since the financial data that we gathered was at a high-level. However, we collected granular data to inform the pass-through analysis and we used this to analyse how MSC changed over time for merchants of different sizes. We therefore do not present data or analysis of MSC by merchant turnover as part of our financial review.

MSC by pricing option

1.53 The financial data that acquirers provided for MSC by pricing option had limitations. One acquirer – [✂] – provided no data. The other acquirers had difficulty classifying their merchants according to the pricing options that we had provided. They reported up to half of their results under the 'Other' pricing option (that is, pricing options not conforming to any of the categories we provided).

1.54 We did not follow this up with acquirers, since we had the alternative of exploring how MSC varies by pricing option using the data we collected to inform the pass-through analysis.[17] We therefore did not analyse the pricing option data further under our financial review.

17 Similar issues with pricing option data arose in the pass-through analysis. However, we were able to resolve these after further discussion with acquirers. See Annex 2, Data Issues section, the table titled 'Consistency of acquirers' allocation of merchants to tariff types'.

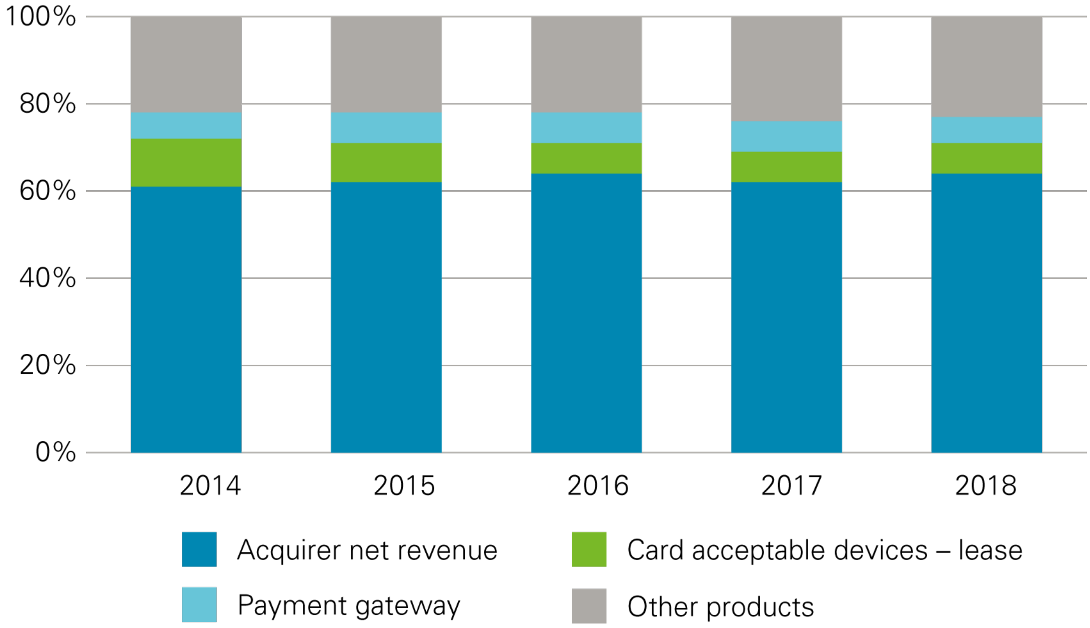
Significance of other goods and services to acquirers' revenues

1.55 In addition to those services included in the MSC, acquirers sell to merchants a range of other services including:

- card acceptance devices
- payment gateways
- value-added services such as dynamic currency conversion (DCC)[18]

1.56 The proportion of merchant revenues earned from card-acquiring services and other services is shown in Figure 3 below.

Figure 3: Product share of revenue (after deduction of interchange fees and scheme fees): weighted average of five largest acquirers



Source: PSR analysis of data provided by the five largest acquirers

1.57 Figure 3 above shows that acquirer net revenues (after deduction of interchange fees and scheme fees) for card-acquiring services accounted for 62% of revenues. Lease of card acceptance devices and supply of payment gateways together provided 15% of revenues and value-added services provided the remaining 23%. (See also Chapter 3 of the interim report where we use this information to provide context.)

1.58 Overall, the product mix of acquirer revenues remained broadly constant between 2014 and 2018 (during a period of overall revenue growth).

18 See Annex 1 for more information on DCC.

1.59 As explained in paragraph 1.29, acquirers were only able to provide limited cost information, meaning that we were unable to analyse the margins relating to each category of product. Without cost information for different types of products, we were unable to assess their relative contributions to profits. Therefore, we could not conclude whether acquirers' business models (particularly for small and medium-sized merchants) relied upon selling high margin additional products, alongside card-acquiring services at narrower margins.

1.60 Although Figure 3 above shows the weighted average product share of revenue, across all of the five largest acquirers, the distributions for individual acquirers varied quite significantly. Two acquirers – [✂] – had significant payment gateway revenue and two acquirers – [✂] – derived significant income from currency conversion (which is included within value-added services above). Another acquirer, [✂].

1.61 The factors driving this variation between acquirers may include: international activity of their merchants, business model and the activities of the wider group (such as banking).

1.62 For the individual acquirers, their distribution of product share of revenue remained largely constant over the five years.

Review of cost information

1.63 Some acquirers told us that an alternative explanation for lack of pass-through of the cost savings they made from the IFR caps could be that they were invested in providing a higher quality of service to their customers rather than lower prices. We examined the cost information we received to see if this indicated that acquirers were making investments to enhance quality of service.

1.64 We received limited cost information from acquirers. We nevertheless carried out a high-level review of the total cost information provided by two acquirers [✂]. We compared the total costs (both direct and non-attributable) reported by these two acquirers in their responses, for each year, against the volume and value of transactions acquired. (This calculation does not strictly provide a unit cost that relates purely to card-acquiring services, since acquirers offer other products and the costs of providing these could be included in total costs. Nevertheless, it may be a helpful proxy. Since the proportion of revenue derived from other products remains roughly constant over time, the trend over time of total unit costs revealed by our calculation should approximate to the trend in card-acquiring services unit costs). This showed that as the volume and value of transactions acquired had increased over the five-year period, the costs per unit had decreased over the period.

1.65 Based on limited evidence, we found that total unit costs decreased over the five-year period between 2014 and 2018. We would have expected to see unit costs increasing, if acquirers were making investments to enhance quality of service and therefore increasing the cost for any given volume all else being equal.

Summary

1.66 We carried out a financial review of the evolution over time of the MSC paid by merchants to the five largest acquirers and its components: interchange fees, scheme fees and acquirer net revenue. We did not carry out the more traditional profitability analysis that we had originally intended and consulted upon. This was because of the methodological difficulties in doing so in the circumstances, the limited data that acquirers were able to provide and the limited benefits that might result from a review of this sort.

1.67 We analysed financial reporting data for the five largest acquirers between 2014 and 2018. Our data was at an aggregate level and as a result was dominated by figures for large merchants (those with annual card turnover of more than £10 million), who account for around 80% of transactions (by both volume and value) acquired by these acquirers.

1.68 Average interchange fees fell significantly between 2014 and 2016 and then remained approximately constant.

1.69 Our financial analysis shows that average scheme fees more than doubled over the period 2014 to 2018, with most of this increase occurring between 2016 and 2018, after the introduction of the IFR caps on interchange fees. Over the period 2014 to 2018, scheme fees rose from [✂]% to [✂]% of card turnover.

1.70 Average MSC fell as interchange fees fell between 2014 and 2016 from [✂]% in 2014 to [✂]% in 2016. However, the decrease in the average MSC is less than the decrease we observe in interchange fees, resulting in a higher acquirer net revenue. After 2016, the MSC increases, mainly driven by a rise in scheme fees.

1.71 Average acquirer net revenue rose from [✂]% to [✂]% between 2014 and 2016, then flattened off. This shows that acquirers increased their net revenue at the same time as interchange fees fell.

1.72 We examined the significance of goods and services other than card-acquiring services to acquirers' revenue. Acquirer net revenues (after deduction of interchange and scheme fees) for card-acquiring services accounted for 62% of revenues. Lease of card acceptance devices and supply of payment gateways together provided 15% of revenues and value-added services provided the remaining 23%.

1.73 Based on limited evidence, we found that total unit costs decreased over the five-year period between 2014 and 2018. All else being equal, we would have expected to see unit costs increasing, if acquirers were investing in enhancing quality of service.

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