IN THE COURT OF APPEAL

APPEAL Nos: C3/2016/4520, A3/2017/0889, A3/20170888, A3/2017/0890, A3/2017/0892, A3/2017/3493

ON APPEAL FROM:
THE COMPETITION APPEAL TRIBUNAL
AND
THE COMMERCIAL COURT
QUEEN'S BENCH DIVISION OF
THE HIGH COURT OF JUSTICE

BETWEEN:

(1) MASTERCARD INCORPORATED
(2) MASTERCARD INTERNATIONAL INCORPORATED
(3) MASTERCARD EUROPE SA (formerly known as MasterCard Europe SPRL)

Appellants (Defendants)

- and -

SAINSBURY'S SUPERMARKETS LIMITED

Respondent (Claimant)

AND BETWEEN:

(1) ASDA STORES LIMITED
(2) ARCADIA GROUP BRANDS LIMITED and others
(3) ARGOS LIMITED and others
(4) WM MORRISON SUPERMARKETS PLC

Appellants (Claimants)

- and –

(1) MASTERCARD INCORPORATED
(2) MASTERCARD INTERNATIONAL INCORPORATED
(3) MASTERCARD EUROPE SPRL
(4) MASTERCARD/EUROPAY UK LIMITED

Respondents (Defendants)

AND BETWEEN:

SAINSBURY'S SUPERMARKETS LIMITED

Appellant (Claimant)

- and -

(1) VISA EUROPE SERVICES LLC
(2) VISA EUROPE LTD
(3) VISA UK LTD
(Together "Visa")

Respondents (Defendants)

AND:

EUROPEAN COMMISSION

Intervener

EUROPEAN COMMISSION'S WRITTEN OBSERVATIONS ON ARTICLE 101(3) ISSUES DATED 6 APRIL 2018

Introduction

1. The Commission makes these Written Observations, further to the direction of Flaux LJ of 23 March, in respect of certain of the issues concerning Article 101(3) in the Agreed List of Issues and in the light of the Phillips J Exemption Judgment.

Did Phillips J err in the standard of proof that he applied to the exemption question in the Visa case, and/or in his approach to the types of evidence that had to be adduced in order to satisfy that standard of proof? (§7(b))

2. The Commission endorses the finding of Phillips J that EU law requires that the assessment of whether an agreement which infringes Article 101(1) creates efficiencies such as to justify exemption under Article 101(3) "must be founded on detailed, robust and compelling analysis and that assumptions and deductions be based on empirical data and facts." (Exemption Judgment §23 citing MasterCard Decision §690)

3. In that regard, the Judge's interpretation of both the Commission's Article 101(3) Guidelines and the MasterCard Decision, in the context of assessing the first condition, is correct: Exemption Judgment §§26-35. As Phillips J recognised, the Guidelines emphasise the requirement on the party invoking Article 101(3) to "substantiate" all efficiency claims, in order to verify the 4 considerations set out at §51 of the Guidelines (Exemption Judgment §26).

4. In particular, economic theory alone will not suffice to satisfy the stringent evidential requirements of the first condition: where the parties invoking Article 101(3) rely on an economic model, they must also "demonstrate"

that the restriction does give rise to the positive effects suggested by the model; if, however, the parties cannot establish that objective efficiencies have in fact arisen – by reference to “convincing empirical evidence on the actual effect” of the restriction – then the theoretical benefits asserted by the parties “cannot be balanced with the restrictive effects”: MasterCard Decision §695. In other words, such unsubstantiated benefits shall not be taken into account in analysing whether the first condition is met.

5. Popplewell J was therefore wrong to find that there is no legal basis for the requirement that, as far as the *type* of evidence necessary to support a claim that the first condition is concerned, robust empirical evidence must be adduced. EU law is clear on the point.

6. The Commission responds below to a number of submissions made by Visa concerning the type of evidence required to satisfy the first condition.

7. First, the Commission rejects Visa’s unsupported claim that “[T]here is a strong public interest in allowing parties to make agreements that satisfy the four cumulative conditions of Article 101(3).” Agreements which restrict competition within the meaning of Article 101(1) will only escape prohibition where they meet the requirements of Article 101(3), which are necessarily stringent to reflect the fact that Article 101(3) is an “exception” to the general prohibition of restrictive agreements under Article 101(1) (Article 101(3) Guidelines §§8-9). In particular, the “spirit” of Article 101 requires that, in order to satisfy the first condition, the parties must show “objective appreciable advantages of such a kind as to compensate for the resulting disadvantages for competition” (Case 501/06 P *GSK*[1] §92, citing *Consten & Grundig* p478[2]). That is why ‘subjective’ advantages enjoyed by the parties themselves to the restrictive agreement are excluded from the analysis; and also why evidence of a factual nature

[1] ECLI:EU:C:2009:610 **[Auth/30.1/87]**

[2] **[Auth/2.1/61]**

must be adduced: *GSK* §§102-103.[3] There is, accordingly, no presumption in favour of exemption under the first condition, as Visa appears to claim.

8. Secondly, Visa's contention that the evidential requirements set out in the MasterCard Decision were specifically tailored to the particular economic theory espoused by MasterCard in that case, known as the Baxter framework, is also incorrect. The requirement for rigorous factual evidence is not context specific; it is an evidential rule of general application under Article 101(3), which applies not only to the assessment of MIFs, but to any agreement which restricts competition within the meaning of Article 101(1), as the Article 101(3) Guidelines make clear.

9. Thirdly, and in any event, there can be no justification for 'watering down' the requirement for rigorous empirical evidence in a case which involves a collective agreement between issuers to impose a charge on merchants designed to increase their own profits: see Exemption Judgment §52. Relaxing the evidential rules in this context would undermine the effective enforcement of EU competition rules.

10. Fourthly, Visa is wrong to contend that §731 of the MasterCard Decision alters the meaning of the unambiguous evidential rules set out at §§690/695 of the Decision, not least because that paragraph must be read together with §732, where the Commission concludes that the analysis must "therefore" (*i.e.* in the light of the preceding paragraphs) rely on "empirical data and facts".

11. Finally, as to Visa's reliance on references to the MIT test in the 2010 and 2014 Commitment Decisions, those Decisions do not provide any meaningful indication of how the Commission approaches the evidential rigours of Article 101(3) in deciding whether to issue an infringement decision. The CJEU has explained in Case C-441/07P *Commission v*

[3] **[Auth/30.1/89]**

Alrosa[4] that: (i) the mechanism by which the Commission can accept commitments proposed by the parties provides "a rapid solution" to competition problems, based on "considerations of procedural economy" (§35); and (ii) commitment decisions and infringement decisions pursue "different objectives" (§46) and are based on "different concepts" (§50). This is precisely why, in the context of the Visa 2014 Commitment Decision, the Commission was content to proceed on the basis of "indications" and "certain assumptions" for the purposes of accepting commitments: see §111.

12. There is accordingly no "read across" from the Visa commitment decisions to the exigencies of the evidential rules for analysing MIFs under Article 101(3), in which context the Commission has consistently emphasised the need for rigorous evidence to substantiate claims of net economic benefits: see for example Visa 2012 SSO at §974[5].

Did Popplewell J. err by adopting an approach to the assessment under the first condition of Art. 101(3) TFEU that was incapable of establishing whether the MasterCard MIFs gave rise to appreciable objective advantages for consumers sufficient to compensate for the disadvantages resulting from the restriction of competition? (§7(c))

13. The Commission considers that Popplewell J did err in the way set out above. The Judge made a number of serious errors of reasoning in his assessment of the evidence under the first condition. By contrast, the approach adopted by Phillips J is correct, and consistent with the Commission's analysis of MIFs under the first condition.

Phillips J approach

14. The overall question posed by Phillips J was whether Visa established to the requisite standard that UK MIFs contribute to net efficiencies:

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[4] ECLI:EU:C:2010:377

[5] **[SvV/94/289]**

Exemption Judgment §50. The Judge found that Visa could not support that claim on the evidence deployed at trial because it failed to establish that (i) MIFs incentivise issuers to take steps to stimulate card usage which they would not otherwise have taken; and (ii) that those steps did in fact lead to increased card usage than would have taken place absent the MIF.

15. In particular, Visa failed to make good those two essential limbs of its case because:

    (a) It did not prove that, without MIF revenue, issuers would not take steps to stimulate card usage, not least given the substantial amounts of non-MIF revenue which are, in any event, generated by the card issuing business: Exemption Judgment §§38-39; and

    (b) It did not prove that a real link in fact exists between any such steps taken by issuers and increased card usage (or increased efficiencies); and no such link exists in a mature card market such as the UK in which a large proportion of card transactions are Always-Card transactions, leaving only a small percentage of transactions which could, in theory, be incentivised to switch to payment cards: Exemption Judgment §49. Without a MIF, most card transactions in such a market would remain card transactions absent the MIF.

The Commission's Approach

16. Phillip J's scrutiny of Visa's evidence to establish whether the scheme had proven net efficiencies on the basis of empirical evidence is consistent with the way in which the Commission approaches the assessment of MIFs under the first condition.

17. The overriding requirement is that the Scheme must demonstrate that its MIFs are "<u>causal</u> for appreciable objective efficiencies of such kind as to offset the resulting disadvantages for competition." (MasterCard Decision

§687) Establishing causation involves consideration of the following critical evidential issues.

18. First, issuer pass-through must be established on the basis of cogent empirical evidence. Unless the benefit of MIF revenue is passed on to cardholders, there is no scope for the issuer to use MIF revenue to stimulate card usage. If MIF revenue sticks in the pockets of the issuing banks, the Scheme's case on the first condition falls at the first hurdle.

19. Secondly, there must be "a reasonable channel through which interchange fees can promote the use of cards."[6] In other words, there must be some available means by which the issuer can stimulate greater card usage. Debit cards, which do not generally involve reward programs will not satisfy this aspect of the test if a higher MIF is not capable of incentivising greater card usage.[7] Or if the MIF is passed through to consumers via non-payment card "channels", such as lower current account fees (given that different retail banking services are often bundled together), again the pass through mechanism is not capable of promoting the use of payment cards.

20. Thirdly, no efficiencies arise out of MIFs on Always-Card transactions since such transactions are not attributable to the MIF. In those circumstances, MIFs simply impose a cost on merchants which they would not otherwise have to bear. The Commission also endorses Phillips J's rejection of Visa's supplemental argument that even though MIFs on Always-Card transactions do not increase card usage, they nonetheless contribute to some other form of efficiency: Exemption Judgment §54.

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[6] Commission Press Release of 1 April 2009 on MasterCard's decision to cut cross-border MIFs ("2009 Commission Press Release"); Cost of Cash Study 2015 §72, 3rd bullet point.

[7] Cost of Cash Study 2015 §72, 3rd bullet point.

21. Thus in mature markets characterised by high levels of Always-Card transactions, fewer transactions are available for conversion from non-card to card payments. Similarly, in the context of online sales, card usage is likely to be near universal, so that there is little scope for MIFs to give rise to net efficiencies. Popplewell J was therefore wrong to deduce from the fact that card use facilitates online sales that such sales must comprise a relevant merchant benefit for the purposes of the Article 101(3) analysis: Judgment §329. The only relevant question under the first condition is whether there is a direct link between online sales and the MIF, which question Popplewell J failed to consider.

22. Fourthly, and following on from the point above, even if some increase in card usage can be proven to be attributable to the MIF, the incremental usage must give rise to a net benefit. There may be no net benefit in mature markets in which there is limited scope for incremental switching to offset the MIF burden imposed on merchants in respect of Always-Card transactions. For example, the Commission has pointed that: "When a payment card would reach universal usage in a market even without MIF, the need to promote the issuing and usage of such a card in terms of network effects would vanish."[8]

23. It is therefore not enough to show increases in card usage attributable to the MIF in order to satisfy the first condition. Critically, the benefits of any incremental card transactions attributable to the MIF must be weighed against the costs of the MIF on card transactions which would have taken place anyway absent the MIF. This is not a matter which can be addressed by way of assumption, but must be demonstrated by reference to empirical evidence.

Popplewell J approach

24. The Judge made the following serious errors of reasoning.

[8] Cost of Cash Study 2015 §72 2nd bullet point.

25. His central analytical error was to assume that “a MIF at <u>some</u> positive level is directly causative of some benefits”, and to move directly from that assumption to “the difficult quantification exercise involved in valuing those merchant benefits which are directly attributable to the MIF.” (Judgment §312). By that logic, the Judge bypassed the critical question, which formed the centrepiece of Phillip J’s assessment, of whether MasterCard had demonstrated, to the requisite standard and on the basis of empirical evidence, the existence of a causal link between interchange revenue and net efficiencies. In other words, Popplewell J simply accepted – as a matter of principle and without reference to the evidence - that increased card usage was a benefit which was attributable to the MIF.

26. That assumption is a serious error of reasoning. As Phillips J emphasised at §9 of the Exemption Judgment, most of the efficiencies which Popplewell J treated as relevant merchant benefits are inherent in any payment card scheme (in respect of which the MIF has been shown, by this stage of the analysis, not to be objectively necessary). As such, it is a fundamental error to treat them as net efficiencies under Article 101(3), in the absence of any evidence directly linking them to the MIF.

27. By this same reasoning, Popplewell J also proceeded on the incorrect assumption that increasing card usage can be assumed to have net beneficial effects for merchants. Although the Judge held that the point had been “made good on the evidence”, the Judgment is silent as to how that critical assumption was in fact substantiated by reference to empirical data. The specific need for concrete proof to support the very same contention concerning output maximisation was upheld by the General Court at §§222, 223 & 227 of its *MasterCard* Judgment, as follows:

> “As regards merchants, while an increase in the number of cards in circulation may increase the utility of the MasterCard system as far as they are concerned, it also has the effect of reducing their ability to constrain the level of the MIF and,

therefore, of increasing the applicants' market power. It is reasonable to conclude that the risk of adverse effects on merchants' custom of a refusal to accept this method of payment, or of discrimination in that respect, is higher the greater number of cards in circulation.

… While it is admitted … 'that, in principle, in a payment card system characterised by indirect network externalities, interchange fees can help optimise the utility of the network to its users', it is also stated … that a MIF may be used by banks in order to 'achieve efficiencies as well as to extract rents'.

…

It must be concluded therefore that, in the absence of proof of a sufficiently close link between the MIF and the objective advantages enjoyed by merchants, the fact that the MIF may contribute to the increase in MasterCard system output is not, in itself, capable of establishing that the first condition … is satisfied."

28. Accordingly, contrary to Popplewell J's finding at §312, MasterCard's central contention that expanding card usage gives rise to net benefits for merchants did need to be substantiated. The Judge's assumption of net benefits to merchants based on output maximisation was therefore fundamentally unsound and vitiates his subsequent quantification exercise under Article 101(3).

29. Secondly, Popplewell J made a serious error of reasoning in his approach to the MIT test, as explained below.

30. The Commission regards the MIT or "tourist test" as "a reasonable benchmark for assessing a MIF level that generates benefits to merchants and final consumers."[9] In other words, it is a useful proxy for identifying

[9] 2009 Commission Press Release.

the level of MIF which is indispensable for producing the net efficiencies, and can therefore assist the analysis under Article 101(3).

31. The MIT test does not, however, displace the need for rigorous scrutiny under Article 101(3) of the factual evidence to determine whether the MIF directly causes net efficiencies. In particular, whether a MIF is capable of giving rise to net efficiencies will depend on the concrete facts relating to the particular card market at issue. The MIT theory is therefore no substitute for compelling factual evidence showing the requisite causative link. For example (subject to Visa's supplemental argument concerning efficiencies for Always-Card transactions), a MIF on an Always-Card transaction simply imposes a cost on the merchant which it would not otherwise have borne, whether or not it is set at the level suggested by the MIT.

32. This has been explained by the Commission, for example, in its Cost of Cash Study 2015, where it underlined that whether the MIT can serve as a useful measure in any particular context will depend "on the specifics of the markets at hand" (§72). The Commission goes on to identify some "(non-exhaustive) cautionary examples" where the MIT test does not serve as a useful benchmark (including those referred to at §§19 / 22 above). This is precisely why general theory alone, without reference to market facts, will not do and is not the approach adopted by the Commission under Article 101(3), contrary to the claims made by Visa.

33. Therefore, Popplewell J's second basic error of reasoning was his implicit assumption that, provided that the level of the MIF is quantified by reference to some metric principally based on the merchant's indifference, it must necessarily generate net efficiencies. As such, the Judge fundamentally misunderstood the use of the MIT as a proxy for efficiencies which must not blindly be applied irrespective of context or elevated to a 'one size fits all approach' at the expense of rigorous factual analysis.

34. Thirdly, Popplewell J's approach of "levelling up" the MIT compounds that basic error since the Judge's adjustments are equally based on a series

of assumptions about the merchant benefits considered relevant by the Judge, rather than any rigorous assessment of whether those assumed benefits were in fact linked to the MIF.

35. By way of example, the Judge assumed that the offer of store credit represents a cost to merchants which is avoided through card acceptance: Judgment §372. But this ignores the fact that providing credit is generally a profitable business, whether offered by banks or merchants. Therefore, the assumption that the provision of credit represents an avoided cost – rather than an avoided revenue stream - may in fact be evidentially untenable, and must therefore be proven rather than simply assumed.

36. Another example relates to the payment guarantee which is not in fact a benefit when comparing cards to cash since the latter involves immediate payment not requiring any guarantee. Rather it corrects a potential deficiency inherent in the nature of card payments.

Did Popplewell J. err by treating "business-stealing" as a relevant benefit for the purpose of Art. 101(3) TFEU? In any event, was the Judge's approach to estimating the "business-stealing" benefit correct? (§7(f))

37. The Commission has already addressed this issue at §§43-44 of its Written Observations of 21 February. In the light of the points made above concerning the MIT MIF, it should be added that the whole thrust of that test is to exclude the business stealing effect which, far from being a benefit, exploits the fact that "individual merchants feel compelled to accept a payment card even if it is more expensive than other payment instruments."[10]

38. This was explained by the Commission in its 2015 Cost of Cash Study as follows:

[10] Cost of Cash Study 2015 §71.

> "Importantly, merchants' perceived benefits of attracting new and not losing old customers by accepting cards are not transactional and are therefore not relevant for the implementation of the MIT. While the competitive desire not to lose customers constitutes a perceived benefit from the perspective of an individual merchant, this is not the case from the perspective of merchants overall. This is because the sales that one retailer loses by turning down cards are the sales won by some other retailer and vice versa. The case of a tourist, i.e. a non-repeat customer, carrying sufficient cash is considered precisely in order to address the phenomenon that merchants feel compelled to accept cards even when these are more expensive than other payment means, in order not to drive customers away ('business stealing effect')." (§74)

39. Popplewell J was therefore wrong to conclude that the exclusion of business stealing renders the MIT test, as applied by the Commission, "inadequate" (Judgment §343). To the contrary, the Commission's view is that it is a positive advantage of the MIT test that it is deliberately designed to exclude the "must take cards" effect on merchants.

40. The Commission endorses the finding of Phillips J at §7 of the Exemption Judgment that:

> "It is apparent from the above that exemption will only be granted to restrictive agreements which give rise to net economic benefits or increases in value: to the extent that a restriction simply benefits one group at the expense of the other (a "zero sum game"), that restriction is not generating an efficiency, but merely transferring value which already exists in the economy. For example, the fact that accepting a payment card enables Merchants to win business from competitors who do not accept that card (referred to as "Business Stealing") is a benefit for the accepting Merchants but not, in itself, for the economy as a whole: their competitors suffer an equal and

> opposite loss, achieving no more than transferring business from one to the other with no net gain."

Did Phillips J err in concluding that, for the purposes of the second condition of Art 101(3), benefits to cardholders can be taken into account as part of the fair share that consumers receive from the MIF, as long as there is at least some objective advantage to merchants, even if the merchants are left worse off overall? / Did Popplewell J. err in his application of the principle (which he considered applied under the second condition of Article 101(3)) that in order for a MIF to satisfy the second condition of Art 101(3) by conferring a fair share of the resulting benefits on consumers, it must not leave merchants worse off overall than without a MIF? (§§8/9)

41. Popplewell J's analysis at §286 is correct: satisfying the fair share requirement is dependent on demonstrating a "net compensatory effect" on merchants as the consumers who are subject to the restriction.

42. The Commission's view is that there can be no "offsetting" in this regard: each relevant group of consumers must receive a net gain; negative effects on one group of consumers cannot be compensated for by positive effects on consumers in a different market. In the context of MIFs, this means that merchants, as the group which bears the cost of the MIF, must be left no worse off as a result.

43. This approach reflects the fundamental aim of the competition rules to enhance consumer welfare and ensure an efficient allocation of resources.[11] Where a group of consumers suffers an overcharge through collective price-setting, overall consumer welfare is not enhanced where that overcharge provides a corresponding boon to a separate set of consumers, who do not bear the burden of the overcharge. The fair share requirement is satisfied only where the consumers who are charged the

[11] See Article 101(3) Guidelines §33.

collectively set price also benefit from offsetting efficiencies which at least leave them no worse off.

44. Phillips J was therefore wrong to find at §63 that overall economic efficiency is maximised in circumstances where merchants suffer a net detriment through the imposition on them of the MIF.

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