

Market review into the supply of  
card-acquiring services

Responses to the approach to  
the profitability analysis  
consultation

December 2019

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Names of individuals and information that may indirectly identify individuals  
have been redacted.

# British Retail Consortium

## BRC response to PSR consultation: Card Market Review – profitability analysis

July 2019

### Introduction

- 0.1 The British Retail Consortium (BRC) is the trade association for the entire retail industry, the UK's largest employer, with a membership accounting for half of UK retail by turnover. Our diverse industry spans large multiples, independents, high street and out of town retailers, from online to bricks and mortar, selling goods across all sectors to increasingly discerning consumers.
- 0.2 All BRC members have an interest in the payment system as end users, in fact retailers are one of the most significant end user groups, processing more than 50 million transactions per day and around £366 billion per year for products & services sold in store, online & over the phone. A priority for the BRC has therefore been to ensure an innovative, transparent and competitive payments market for all retail end users and their customers.

### 1 Objectives for profitability analysis and measures

- 1.1 The BRC is supportive of the proposed objectives of the profitability analysis and the measures the PSR proposes to use against each question.
- 1.2 **Lack of competition:** Members reiterated previous observations that ahead of the introduction of the IFR, and following it, there was variability or in many cases a total absence of information provided to merchants by card-acquirers regarding the application of interchange fee caps. Following the implementation of the IFR it became clear, to the surprise of many – including retailers and Government officials, that acquirers had decided to apply the IFR caps in their dealings with card issuers from the date of introduction yet withhold those benefits from many of their (smaller) merchant customers, not on Interchange++ contracts. In these cases, the card-acquirers were the beneficiaries of the IFR rather than the end-users that the legislation had intended to benefit. This is contrasted with the approach taken in other industries, including telecoms where the introduction of roaming fees saw mobile phone operators promote the statutory price caps as a tool to win over new customers and increase their market share.
- 1.3 **Bundling:** The BRC welcomes the disaggregation of the three broad product groups (card-acquiring services, card acceptance products and other goods and services) by the PSR for the purposes of this analysis given the concerns among smaller retailers around bundling. BRC members have expressed that the packaging of payment services leads to a lack of transparency or visibility in service-provision, hidden and inflated costs for merchants, and creates difficulty for merchants in negotiating the best prices (similar to telco services, where long contract pricing models for hardware often incur higher costs for end-users).
- 1.4 **Tiering:** The BRC welcomes the consideration of profitability across broad types of merchant by the PSR for the purposes of this analysis. Our members emphasised the impact of retailer size, or 'tiering', on both formal and informal aspects of the commercial relationship. Tier 1 merchants are more likely to find it difficult to move between acquirers to secure the best deals (due to the full accreditation required, for example). And whilst lower tier merchants may find it easier to switch between card-acquirers they often lose out through lack of transparency or visibility in service-provision, and find it more difficult to challenge charges, negotiate the best prices or secure the favourable contractual terms through their Service Level Agreements (SLAs).

## 2 Approach to and adequacy of analysis

- 2.1 **Time-frame:** Concerns were expressed around the proposed time periods of the data set as set out in 1.15. It is important to note that merchants experienced significant reductions in interchange fees immediately ahead of the of the IFR coming into effect owing to the outcome of litigation. The data set immediately prior to December 2015 is therefore unreliable as a comparator for reductions after December 2015. Our members have suggested that the data should cover the time period from 2 years before December 2015 for effective comparisons to be made of at least 1 year after – measuring from immediately before December 2015 would not be adequate.

### For further information

[REDACTED]

# EVO Payments

**From:** [REDACTED]  
**To:** [cards@psr.org.uk](mailto:cards@psr.org.uk)  
**Subject:** Payment Systems Regulator (PSR) Consultation on our proposed approach to the profitability analysis as part of our market review into the supply of card-acquiring services  
**Date:** 01 August 2019 17:07:11  
**Attachments:** [EVO\\_6cbfdd08-959e-4386-bd7c-a5e144a04280.png](#)  
[evo2.jpg](#)  
[Sample Simplified Merchant Acquirer Profit & Loss account.pdf](#)

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Dear Sir/Madam

I refer to the PSRs email dated 11 July 2019, outlining the approach to profitability analysis as part of the PSRs market review and provide feedback below which EVO believe will assist the review.

To achieve the key objectives outlined in the consultation paper on the PSRs approach to profitability analysis, including comparing profitability of acquirers using various benchmarks, understanding how significant other goods and services are for the profitability of acquirers and how they impact the profitability of card-acquiring services, EVO suggests that the PSR uses standard industry terminology in ascertaining profitability of acquirers and further disaggregates data to eliminate the risk of soliciting data from acquirers that will not enable accurate comparisons or cover the scope of analysis of the PSR.

The above approach will reduce the need for adjustments, provide a consistent approach to the disaggregation of data by acquirers, provide consistency in cost classification across acquirers and enable accurate comparisons between acquirers. The approach will also provide the desired insight (and facilitate analysis) into the significance of other goods and services and their impact on the profitability of card-acquiring services.

Key Performance indicators used in your analysis may include:

- Total volume of payments processed
- Number of Payment terminals rented to merchants
- Merchant Service charges
- Interchange fees
- Scheme fees
- Net acquiring margin
- Terminal rental fees
- Value added service fees
- Fees from PCI programmes and fines for merchant non-compliance
- Net Revenue
- Sales commission paid to third parties
- Costs related to transaction processing
- Costs related to terminal provision
- Other variable costs
- Net margin
- Sales, general and administrative costs (excluding sales commissions to third parties)
- Other fixed costs
- Operating margin

Please find a simplified profit & loss account attached, outlining the above metrics used to build the statement.

I hope the feedback will be of assistance as part of your review.

Please let me know if you require any further information or clarification in relation to the above or attached.

Kind regards

## Simplified merchant acquirer P&L

*Numbers for illustrative purposes only*

### KPIs

Total volume of payments processed £100,000,000

Number of payment terminals rented to merchants 1,000

	P&L	Revenue	Cost
Merchant service charge		£1,000,000	
Interchange fees			£240,000
Scheme fees			£60,000
<b>Net acquiring margin</b>	<b>£700,000</b>		

*Net acquiring margin (net revenue divided by total volume of payment processed)* 0.70%

Fees from renting terminals to merchants £144,000

Fees from value added services £24,000

Fees from PCI programmes and fines for merchant non compliance £60,000

Sales commissions paid to 3rd parties £100,000

**Net revenue £828,000**

*Net revenue margin (Net revenue divided by total volume of payments processed)* 0.83%

Costs related to transaction processing £66,667

Costs related to terminals provision £96,000

Other variable costs £50,000

**Net margin £615,333**



Sales, general and administrative excluding sales commissions to 3rd parties	£250,000
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Other fixed costs	£100,000
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<b>Operating margin</b>	<b>£265,333</b>
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<i>Operating margin (operating profit divided by total volume of payment processed)</i>	<b>0.27%</b>
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# Global Payments

# GPUK – Response to PSR profitability analysis consultation

## 1. Overview

GPUK welcomes the chance to comment on the PSR's consultation on the approach to the profitability analysis.

In summary, GPUK highlights the following.

[CONFIDENTIAL]

This has two implications for a profitability assessment that uses GPUK data. First, a GPM metric based on GPUK's management accounts would be specific and unique to GPUK's internal reporting structure; it could not meaningfully be compared against other card-acquirers or other benchmarks.

[CONFIDENTIAL]

Regarding the PSR's proposal to calculate the return on capital employed (ROCE), GPUK submits that there are substantial challenges in obtaining any meaningful estimate in practice.

- There is not a standard measure of EBIT for GPUK. [CONFIDENTIAL]
- GPUK does not produce or rely on a measure of ROCE in the normal course of business. In particular, the performance of GPUK is not assessed by Global Payments Inc. on the basis of ROCE.
- Suppliers of card-acquiring services are likely to have a relatively high ratio of intangible assets ("intangibles") to total assets. Since intangibles (and hence the value of capital employed) are difficult to quantify, the estimated ROCE is likely to be sensitive to how intangibles are measured.
- [CONFIDENTIAL]
- GPUK expects suppliers of card-acquiring services in the UK to have different approaches to cost allocation and different scope to benefit from shared assets. These factors add to the difficulty of both obtaining a reliable estimate of profitability at the market level and making comparisons across industry players.

A further challenge relating to any measure of profitability is the fact that information in GPUK's management accounts and financial accounts is not comparable year-on-year.  
[CONFIDENTIAL]

For the preceding reasons, GPUK does not think that the measures suggested by the PSR (i.e. GPM and ROCE) would meaningfully reflect GPUK's profitability for the purpose of conducting a competitive assessment. In addition, GPUK would highlight that a profitability assessment can only constitute one part of the competitive assessment and must be viewed in light of other evidence on market conditions, namely existing competition, potential competition and buyer power. As GPUK has explained in its Response to the PSR's Formal Notice 1, these conventional metrics indicate effective competition among suppliers of card-acquiring services.

Indeed, GPUK considers the market to be dynamic, not only in terms of new entry and growth but also the emergence of a range of different business models. GPUK competes with many rivals beyond the largest acquirers that the PSR indicates it will consider in its assessment of profitability. GPUK encourages the PSR to consider the full range of competitors in its competitive assessment and not limit its analysis to the largest five card-acquirers which are the subject of the PSR's review of profitability.

These issues are discussed in further detail below.

## **2. [CONFIDENTIAL]**

[CONFIDENTIAL]

### **2.1 GPUK financial metrics reflect its position as a “business within business”**

GPUK is a subsidiary of Global Payments Inc. During the normal course of business, GPUK's performance in card-acquiring services is evaluated on metrics [CONFIDENTIAL] designed to permit management to compare the performance of different businesses under Global Payments Inc. (e.g. compare GPUK's performance with that of another subsidiary). These metrics do not constitute a meaningful standalone metric for the purposes of conducting an assessment of economic profitability. [CONFIDENTIAL]

### **2.2 It is not practicable to obtain a meaningful GPM from GPUK financial data**

The PSR indicates that one measure it will consider is the GPM, defined to be revenue less costs of goods sold, all divided by revenue. In turn, the PSR identifies costs of goods sold to be “direct selling costs and other relevant direct costs”. The PSR states that it does not propose to use GPM as a metric for comparing profitability across providers. Instead, it proposes using GPM to study patterns over time and across merchants for the same acquirer (paragraphs 2.21-2.23).

GPUK agrees with the PSR that the GPM is not appropriate for making comparisons across providers because providers are likely to have different approaches to calculating margins in the normal course of business. [CONFIDENTIAL]

In summary, GPUK data are not suited to obtaining a meaningful measure of GPM. It is important also to emphasise that a like-for-like comparison of margins over time would be hindered by the changes to the GPUK management accounts and financial years periods discussed below.

## **2.3 ROCE is not a suitable measure for assessing the profitability of card-acquiring services**

The PSR advocates that its main measure of profitability would be the ROCE. However, GPUK's view is that the ROCE is not a suitable measure for assessing the profitability of card-acquiring services and that it is not practicable to obtain a meaningful measure of ROCE from GPUK financial data.

The first point to note is that GPUK does not produce or rely on a measure of ROCE in the normal course of business.

Second, as the PSR is aware, in order to calculate ROCE, a meaningful measure of EBIT is required. [CONFIDENTIAL]

Third, there are also substantial challenges in appropriately measuring GPUK's asset base, such as the following:

- Card acquiring is an industry characterised by a relatively high ratio of intangible to total assets. For the purpose of a profitability assessment, it is important to take an economics-based approach to the measurement of intangibles, i.e. taking such assets into account even if they would not meet the strict accounting criteria for an intangible asset. Examples of "economic intangibles" include the value of GPUK's brand, know-how and experience of its employees, and customer relationships.
- GPUK considers that it would be very difficult to identify and value all relevant assets and further submits that any estimates would be subject to a wide margin for error due to the large number of assumptions which would need to be made. For example, GPUK benefits from the fact that many of its staff, including senior management, have been in the card-acquiring sector for a long period of time and so know the needs of their customers very well. While undoubtedly an important asset for GPUK, it is hard to put a value on this.
- A significant proportion of the intangible asset base on which GPUK relies is not dedicated solely to serving GPUK's card acquiring services, but also serves other subsidiaries of Global Payments Inc. GPUK considers that it would be very difficult to measure asset values themselves, let alone how those values should

then be allocated to GPUK's card-acquiring business. For example, knowhow and innovation in product development derived from a team based in the US that serves all geographies would have to be valued and then part of that value would have to be apportioned to the UK.

For the reasons above, GPUK does not consider it practicable to assess its intangible asset base in a meaningful way and certainly not in a manner which would allow for a competitive assessment. Related to this, GPUK would like to draw attention to the fact that when investigating the market for investment consultants (a market characterised by a high proportion of intangible assets), the CMA formed the view that it would be disproportionate to attempt to assess the intangible asset base and so ultimately did not consider ROCE.<sup>1</sup>

Finally, turning to tangible assets, it is noteworthy that assets recorded in GPUK's financial reports are likely to understate its total tangible asset base. [CONFIDENTIAL]

## **2.4 Lack of comparability over time**

GPUK agrees with the PSR that a meaningful analysis of profitability would require information over time. However, GPUK sees considerable difficulties in year-on-year comparisons using its management and financial accounts.

[CONFIDENTIAL]

The year-end date of GPUK's financial reports also changed in 2016 from May to December, meaning that June 2016 to December 2016 was a "stub year" in GPUK's financial reports.

## **2.5 Implication for measures of profitability**

In summary, the implications are as follows:

- [CONFIDENTIAL]
- It would not be possible to obtain a meaningful measure of ROCE for GPUK's card acquiring business.

## **3. A profitability analysis has to be seen in the context of the overall competitive assessment**

For the reasons explained in the preceding section, GPUK welcomes the view of the PSR that the profitability assessment will be considered in the context of the PSR's overall assessment. Indeed, GPUK considers that a profitability analysis can (at most) only constitute one part of the competitive assessment. Alongside such profitability analysis, it is important to assess competition by the available other measures.

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<sup>1</sup> CMA (26 April 2018). Investment Consultants Market Investigation - Working paper: Financial performance and profitability, para. 73.

As submitted in GPUK's response to the PSR's Formal Notice 1, competition in the card-acquiring market can be assessed by relying on a number of conventional and reliable measures – with these factors providing considerable evidence of effective existing and potential competition (notably from a wide range of different business models and by no means limited to the largest five acquirers that the PSR is considering in its proposed profitability analysis) and buyer power in the market for card-acquiring services.

## 4. Responses to the PSR's questions

The consultation document identifies five questions at paragraph 4.2. These are addressed in turn below.

- Does the PSR have the right objectives for its profitability analysis, given the aim of this market review?
  - GPUK does not consider that the PSR will likely be able to estimate a reliable range for the ROCE. Therefore, it considers that the objectives of measuring and comparing the profitability of card-acquirers are not practicable.
  - As regards the PSR's desire to assess the impact on profitability of the introduction of the Interchange Fee Regulation Caps in December 2015, GPUK notes that this question relates closely to the question of whether lower interchange costs were passed on to merchants. In that regard GPUK refers the PSR to its response to the pass-through methodology consultation.
- Has the PSR selected suitable measures of profitability, given its objectives?
  - As above, GPUK does not consider the ROCE to be a suitable measure for the card-acquiring services market.
  - [CONFIDENTIAL]
- Do stakeholders agree with the PSR's proposed approach to benchmarking and do they have views on how to establish a suitable range of values for comparison?
  - Putting aside concerns about the suitability of the ROCE in the card-acquiring services market, economic theory indicates that even in a perfectly competitive market, the most efficient firms may persistently earn above normal profit. This would occur if the long run supply curve slopes upwards.
  - For the above reason, as well as the practical difficulties measuring ROCE, GPUK does not consider that a ROCE that persistently and substantially exceeds the WACC is necessarily a sign of weak

competition – other evidence on market outcomes (namely existing competition, potential competition and buyer power) would need to be assessed and given due weight.

- GPM is not likely to be valid for comparing GPUK's performance against other card-acquirers or other benchmarks (such as the GPM in other industries). This is because card-acquirers are not likely to adopt a consistent approach to cost and revenue allocation that would permit a like-for-like comparison. [CONFIDENTIAL]
  - [CONFIDENTIAL]
- Has the PSR identified all the material types of adjustment to data?
  - GPUK has noted the difficulties in measuring the ROCE above. Because GPUK does not produce a measure of ROCE in the normal course of business, it is not in a position to identify fully the number and nature of adjustments and assumptions required to produce this measure.
  - The PSR is correct to identify the need to allocate costs appropriately for the purpose of calculating the GPM [CONFIDENTIAL].
- Will the PSR's proposed process be adequate to generate a reliable analysis, given its objectives?
  - For the reasons stated above, GPUK does not consider that the PSR will be able to obtain a meaningful measure of industry profitability or obtain reliable comparisons of profitability among card-acquiring services providers.



# Lloyds Banking Group

From: [REDACTED]  
To: [REDACTED]; [cards@psr.org.uk](mailto:cards@psr.org.uk)  
Cc: [REDACTED]  
Subject: FW: Comments from the Working Group on the PSRs Approach to Profitability Analysis  
Date: 01 August 2019 17:04:01  
Attachments: [image001.png](#)

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**Classification:** **Limited**

[REDACTED] – in response to your proposed approach on Profitability:

Cardnet agrees with many of the points raised by the UK Finance response to the PSR's "Approach to Profitability" Analysis. There are a number of additional areas to highlight on Profitability Analysis. These are consistent with UKF's general observation that acquirers' differing approaches make robust profitability comparisons extremely challenging.

#### **Principles of Analysis**

[REDACTED]

#### **Implementation / Calculation**

[REDACTED]

#### **Interpretation of findings**

[REDACTED]



[REDACTED]  
Competition and Regulatory Strategy, Customer Development and Innovation, Retail  
**LLOYDS BANKING GROUP**  
**HELPING BRITAIN PROSPER**  

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**M:** [REDACTED]  
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# Mastercard

# Profitability analysis in the market review of card-acquiring services

Submission to the Payment Systems Regulator

31 July 2019

Mastercard has engaged Oxera to provide expert support over the course of the market review into the supply of card-acquiring services, being undertaken by the Payment Systems Regulator (PSR). This document responds to the PSR's consultation on the regulator's proposed approach to profitability analysis in the context of this market review.<sup>1</sup> Oxera has prepared this submission on behalf of Mastercard, as part of the latter's overall engagement with the PSR and responses to all consultations and working papers.

It is positive that the PSR has published its methodology for public consultation, and we welcome the opportunity to comment on the proposals on behalf of Mastercard.

Profitability analysis is a standard tool in market reviews in the UK.<sup>2</sup> Analysis of observed profits can be used as an indicator of competitive conditions in a market. Where profits are persistently above 'normal' returns, this may be a signal that there are shortcomings with the competitive process (e.g. barriers to entry, market power, or coordination).<sup>3</sup>

However, it is important that profitability analysis is interpreted carefully and is not considered in isolation. A finding of high profitability (particularly over a short period) is not conclusive evidence of an absence of competition. At the same time, a finding that profitability is in line with 'normal' returns does not imply that competition is working effectively.<sup>4</sup> The PSR's consultation document acknowledges this, and recognises that profitability should be

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

<sup>2</sup> The role, design and interpretation of such analysis are discussed in Competition Commission (2013), 'Guidelines for market investigations: Their role, procedures, assessment and remedies', CC3 (revised), April.

<sup>3</sup> Competition Commission (2013), op. cit., p. 28, para. 119.

<sup>4</sup> For example, an inefficient monopoly may make normal profits even if it faces few competitive constraints.

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considered alongside the other evidence gathered as part of the market review.<sup>5</sup>

**Do we have the right objectives for our profitability analysis, given the aim of this market review?**

The consultation document identifies that the objectives of the profitability analysis are to analyse:

- the general profitability of card-acquiring services;
- differences in profitability across acquirers;
- changes in acquirers' profitability over time, and, specifically, what this indicates about the extent of pass-on following the introduction of caps on interchange fees;
- differences in profitability for servicing different types of merchant;
- the significance of other services to acquirers' profitability.<sup>6</sup>

The PSR has not directly linked these five areas of analysis to specific theories of harm. However, these are seemingly reasonable aspects of profitability to examine as part of a market review.

The critical factor will be how the PSR uses its findings in these areas, and the inferences that it draws regarding competition. Particular caution will be needed when interpreting any differences in profitability across acquirers and over time. A wide range of factors may affect the relative levels of profitability achieved by the various acquirers. Moreover, trends in profitability over time will reflect changes in the market (e.g. economies of scale driven by consolidation), which could make it difficult to isolate the impact of the interchange fee cap.

**Have we selected suitable measures of profitability, given our objectives?**

The internal rate of return (IRR), which is based on cash flows, is generally considered the theoretically correct measure of profitability.<sup>7</sup> The PSR argues that there are practical difficulties in implementing an IRR approach, although it does not expand on what these are. The key difficulty is usually valuing opening and closing assets.

Where there are practical difficulties with calculating the IRR, it is common practice in market investigations to use other measures of profitability. The economic characteristics of the market under review affect the relevance of different profitability measures. Measures of the return on capital are typically more relevant in capital-intensive industries. Alternative metrics, such as return on sales and profit margins, may be more relevant where there is lower capital intensity.

The two metrics that the PSR proposes to use—the return on capital employed (ROCE) and the gross profit margin—are standard measures used to assess profitability.<sup>8</sup> The PSR indicates that the ROCE would be the main metric for

<sup>5</sup> Payment Systems Regulator (2019), op. cit., para. 1.17.

<sup>6</sup> Ibid., p. 4, para 1.7.

<sup>7</sup> Oxera (2003), 'Assessing profitability in competition policy analysis', prepared for the Office of Fair Trading.

<sup>8</sup> For example, the CMA has analysed the ROCE for numerous market investigations, including those into the energy market, local bus services, and airports.

assessing industry profitability, while the gross profit margin would be used to examine trends over time and between different types of merchant.

For the ROCE to represent a reliable measure of the card acquirers' profitability, the PSR will need to have sufficient confidence that the measure of capital employed that is used in the calculation takes into account all assets employed by these businesses (regardless of accounting treatment). This may include assets that are not recognised on the balance sheet, such as the customer relationships, brand value, a skilled workforce, certification/accreditation, and additional working capital that would be needed for a stand-alone business (including contingency and risk capital). Adjusting financial information to take account of these intangible assets may be a substantial exercise that will require careful analysis and judgement.

We agree with the PSR that it is appropriate to look at multiple measures of profitability. In this context, there may be merit in analysing operating margins, as well as gross profit margins. This would not require additional information as the PSR is already requesting that acquirers provide data on operating profits (EBIT) and revenues. The operating margin has the benefit that it takes account of operating expenditure, as well as the cost of goods sold.

**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?**

The PSR proposes to use a (pre-tax, nominal) estimate of the weighted average cost of capital to benchmark the ROCE. We agree that this is the most appropriate benchmark. The standard methodology for estimating the cost of equity is the capital asset pricing model. The most significant challenge will be in estimating the beta for a stand-alone card acquirer.

We note that the PSR may need to be cautious if looking to make comparisons between the margins earned from different merchant types without making adjustments. For example, if greater working capital is tied up in serving one type of customer, this may confer higher margins. The PSR may therefore need to consider the extent to which comparisons of margins are like-for-like and/or whether differences in profitability are justified by differences in capital requirements or levels of risk in serving these different types of merchant.

**Have we identified all the material types of adjustment to data?**

Given the purpose of the PSR's analysis, it is appropriate to consider economic profits as opposed to accounting profits. As the PSR recognises, this means that adjustments will need to be made to accounting data. The key adjustments include:

- allocating costs and revenues to different products, geographies and merchant types;
- revaluing the capital base to reflect the current opportunity cost of owning the assets, where this is materially different from the (historical) costs recorded in the accounts;
- valuing intangible assets that are not captured in the accounts.

We consider that the PSR is correct to identify these adjustments, and we note that they may have a significant impact on the calculated profit.

However, there is considerable detail to work out in terms of how these adjustments will be implemented. Companies may take different approaches in preparing their adjusted data, which could affect the comparability of the reported profit metrics.

In particular, the PSR has not provided guidance on how companies should revalue their recorded and unrecorded assets. In economic profitability assessments, assets are typically valued according to the 'value-to-the-owner' principle (also known as the 'deprival value'). This values the asset as the lower of:

- the cost of replacing the asset (known as the 'modern equivalent asset value');
- the recoverable value of the asset, which is the higher of the amount that could be obtained by selling the asset and the net present value of future cash flows from operating the asset.

Similarly, there are generally accepted criteria for determining whether proposed intangible assets are suitable for recognition as part of a business' capital employed.<sup>9</sup> We would encourage the PSR to clarify its expectations and criteria, and the extent to which these are the same as the CMA's guidelines.

Finally, we anticipate that there will be significant challenges in allocating common costs between different products and geographies, given the degree of joint production. Different acquirers may adopt different cost allocation approaches when providing data, given their different organisational structures, activities and business models. The PSR should consider whether this has a material impact on the profitability analysis.

**Will our proposed process be adequate to generate a reliable analysis, given our objectives?**

There is no straightforward answer to this question. The PSR's high-level methodology is theoretically sound and generally consistent with the approach adopted by the CMA and other regulatory bodies in undertaking market investigations.

The reliability of the analysis will depend on how this approach is implemented in practice by both the PSR and the acquirers, who will be responsible for providing the data and proposing adjustments.

We note that the PSR's methodology document is very high level and does not set out in detail the approach acquirers should follow in preparing their financial data. Consequently, we would welcome the opportunity to provide further comment once the PSR is in a position to set out its approach in more detail.

Measurability issues are common in profitability assessments, and we anticipate that it will not be a straightforward exercise to allocate costs and revenues or to estimate economic asset valuations.

As discussed above, the PSR will need to give careful consideration to how it interprets the profitability analysis, and to the weight that it places on this analysis (relative to other information) as it forms its views on the card-acquiring market.

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<sup>9</sup> Competition Commission (2013), op. cit., Annex A, para. 14.

# Senior Officials Group



## Market review into the supply of card-acquiring services

### Consultation on the approach to the profitability analysis

July 2019

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*“The overall approach suggested is reasonable. [We are] supportive of the use of ROCE, as a good baseline measure of performance; complemented by the use of Gross Profit Margin.*

*The only reservation [we] have is around the need to tighten up the proposed controls around the use of management accounting numbers – the consultation mentions in para 3.16 the need for acquirers to provide assurance by submitting reconciliations of all data to their audited financial statements, but [we] would suggest these reconciliations are subject to a formal assurance review by an independent professional services firm to ensure a consistent approach is adopted by all acquirers. This feedback would be best placed in response to the final bullet point question under para 4.2.”*

- *BP 1 Objectives: As part of considering whether the supply of card-acquiring services is working well for merchants, the review should examine not just profitability, but also whether the costs to the merchant are commensurate with the service(s) being provided. As a Merchant, we have experienced wildly different costs for processing and gateway charges from different Acquirers*
- *BP 2 Measures: As BP 1*
- *BP 3 Approach: Agree, in context of limited information provided*
- *BP 4 Adjustment: Agree, in context of limited information provided*
- *BP 5 Adequacy: As BP 1.*
- *We would also like the review to consider how fees are applied. For example, SCA is being introduced to combat fraud for issuers and customers. However, as a result of the new legislation we have been advised by our Acquirer that, despite being a merchant with an exceptionally low fraud rate, we will be charged an extra fee (for ALL transactions – whether successful or not) to reflect the increased level of checking required.*
- *Added to this, we would comment that we believe a wider review of card services that includes issuers and card schemes, would be beneficial as:*
  - *Changes to legislation generally fall to the merchant to fund. Fees being applied by these entities are currently exploiting a market with few players and high barriers to entry to price excessively. This is a disincentive to economic activity generally and, for those in the public sector, a significant cost in public money, unless we deny people the ability to pay by card*
  - *Pricing structures that charge high fees on large transactions are a particular problem for organisations like us with high average transaction values. For example, a card payment of £97000, attracts fees of over £2700. By comparison the cost for a Faster Payment of equal value is almost negligible*
  - *Unless costs can be reduced, we will be left with an invidious choice between denying people the option to pay by card, or permitting the situation to continue whereby people who pay by less expensive methods are cross-subsidising the rewards and benefits enjoyed by those paying by card.*

## UK Finance

# PSR Market Review into the supply of card-acquiring services: Consultation on the approach to the profitability analysis

**Date:** 1 August 2019

**Address:** UK Finance, 5<sup>th</sup> Floor, 1 Angel Court, London, EC2R 7HJ

**Sent to:** [cards@psr.org.uk](mailto:cards@psr.org.uk)

UK Finance is the collective voice for the banking and finance industry.

Representing more than 250 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

## General comments

UK Finance welcomes the opportunity to engage with the latest stage of the PSR Market Review into the supply of card-acquiring services by inputting on the general approach of this working paper; *Consultation on the approach to the profitability analysis*.

Due to the commercial sensitivities involved and when considering a profitability/ economic analysis of this sort UK Finance's response has purposefully been kept at a high-level. Our general comments are as follows:

- UK Finance welcomes the PSR's acknowledgement in recognising the associated difficulties and challenges of conducting a profitability analysis, and the fact that it needs to be considered alongside other evidence gathered during the course of this market review<sup>1</sup>.
- In this context, UK Finance would remind the PSR that a general assessment of 'how profitable' the supply of card-acquiring services is, using the proposed *ROCE* vs. *WACC* approach is likely to be very heavily driven by accounting and economic adjustments, many of which are open to considerable subjectivity. The PSR should, if it commences this analysis, be prepared to discard it, if it is not sufficiently robust, as many authorities have done so in the recent past.
- UK Finance would respectfully point out the PSR's working paper offers little of any substantive guidance in how the industry should engage with the complexities of the profitability analysis given the nature of the industry. UK Finance would reiterate that more guidance is needed above and beyond the high-level principles as being referenced to (at Annex A).
- UK Finance would point to three key concerns based on what is set out at Section 3 (Adjusting Accounting Data):
  - That the proposed methodology will impose disproportionate costs and lead to an undue regulatory burden being placed on each of the individual acquiring companies concerned. We further consider that the overall exercise is disproportionate to the potential insight into how competition works, given the inherent difficulties and uncertainty of the analysis.
  - UK Finance would reiterate the reasonableness and proportionality of any such request should be being considered in the wider context of many acquirers' *business-as-usual* statutory reporting requirements, other 'live' regulatory programmes (e.g. *Brexit*, *PSD 2 (including SCA)*), normal operating business responsibilities, and investor relations reporting obligations.

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<sup>1</sup> As highlighted at paragraph 1.17

- Given the complex nature of the acquiring industry and subjectivity that is normally involved in asset/ cost valuation and allocation, the *ROCE* vs. *WACC* analysis may not be sufficiently robust to draw any conclusions, even if considerable effort is expended by both the PSR and industry over the coming months.
- UK Finance would encourage a working group; or some other more harmonized and agreed methodology (including a wider sub-set of interested stakeholders reflective of the wider payment ecosystem), rather than what is being suggested (i.e. having the five companies themselves proceed independently with a complete analysis that is then submitted to the PSR for assessment).

Our more specific observations, and subsequent comments are more thematic in tone, rather than a comprehensive set of individual responses to each of the questions as are posed in the proposed consultation paper<sup>2</sup>.

Our response is focussed on three distinct subject headings and as are reflected in the main body of the text – these include:

- Consideration of the principles of the analysis;
- Challenges to implementation/ calculation of profitability measures; and,
- Issues around interpretation and future conclusions.

## Consideration of the principles of the analysis

UK Finance appreciates that the proposed measure of profitability (i.e. return on capital employed (*ROCE*), weighted average cost of capital (*WACC*), and gross profit margin (*GPM*) have all been used in UK market review/ investigation precedent.

However, we note that the *ROCE* vs. *WACC* approach has in practice mostly not been used by UK regulators; to our knowledge it has only been applied fully in two of the last twenty market studies by the PSR, FCA or CMA.

Geographic and product scope issues will be very complex, due to the global nature of the acquiring market and the way individual acquirers sell multiple products. When looking at recent reviews/ studies undertaken by the PSR, FCA and CMA it is our understanding that none have successfully completed both a geographic and scope allocation; and, as the PSR is now intending.

A further issue that compounds the uncertainty and ‘comparability’ of the results of the analysis, is both the geographic and product scope cost and revenue allocations that will need to be made to focus on the PSR's reference market.

The economic value of assets will be very difficult to determine.

This is particularly challenging in any industry where much of the value is generated from a range of intangibles (e.g. *software development, research and development, IT security, network resilience, reputation/ goodwill, brand value, relationship management (including data security/compliance)*). All are difficult to identify, and are not recognised as classic ‘fixed assets’, making it hard to ‘value’ the asset base with any degree of accuracy.

This differs markedly when compared to other industries that possess a more readily and identifiable tangible capital base (e.g. utilities/ energy sectors).

Even for those sectors, which have been subject to market reviews/ investigations in recent years, the use of such measures (i.e. *ROCE* vs. *WACC*) to assess profitability have seldom been pursued, because of the inherent difficulties of being able to draw any significant conclusions as a comparison measure (for example, the CMA's audit, retail banking or investment consultants market investigations).

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<sup>2</sup> As stipulated at paragraph 4.2.

The FCA also decided not to conduct a detailed profitability analysis in the cash savings market study, noting that the data requests would have been overly burdensome and that, due to the complexities in that market, it was unlikely that the conclusions would have significantly enhanced the evidence base.

The PSR should therefore be under no illusion, nor underestimate, how complex a task this has proven to be.

We would therefore suggest that though useful in *'theory'* such measures are often *'problematic'*, particularly in industries that do not depend on the existence of a range of tangible assets such as card acquiring.

With regard to the use of Gross Profit Margin (GPM) as a *'tool'* in the profitability analysis, we would express concerns that this cannot be meaningfully used when comparing different merchant groups, because there are likely to be significant differences in their indirect costs, which would not be reflected in this kind of measure making it difficult to interpret in practice.

### Challenges to implementation / calculation of profitability measures

UK Finance would reiterate its concern that because of the complexities of the acquiring market any analysis of this kind is fraught with complexity with considerable scope for subjectivity.

Acquirers generally operate through large global platforms, purposefully designed to maximize the efficiencies in running enterprises of this sort, and whose role represents an integral element in supporting a global payment network.

Many larger acquirer organisations have global R&D operations/ network capacity that are designed to facilitate a range of cross-border payments across multiple jurisdictions to help serve their merchants' needs. Those merchants, in turn, may have differing service requirements based on their presence, maturity and commercial ambitions at a local market-level.

This means it is very complex to then attribute and separate out any future allocation of assets, costs or revenue for one individual jurisdiction by identifying 'UK business' as a distinct revenue stream from other parts of the same business, which can often be further complicated by regional differences reflective of previous legacy acquisitions and systems operating at a regional and/or country level.

Furthermore, acquiring may not be the only service being offered to an individual merchant customer.

Acquiring may be a distinct service offered in conjunction to a host of other value-added elements (e.g. financing/ small business lending) which might be inclusive as an additional service; or, where a singular function (e.g. *PoS device/ gateway service*) is provided in isolation, as a bespoke element to satisfy the requirements of an individual merchant.

This raises practical problems in how you separate out; or, begin to identify, the 'value' of the assets on offer.

There is the further challenge of implementing these measures, on a consistent basis, across five acquiring businesses that operate under very different business models.

Not least in that there exists a full range, and separate categorisation of issues, that could be raised based on any future individual request for information (RFI) that might significantly impact on how that profitability calculation is made. These issues could include:

- valuing intangible assets;
- revaluing tangible assets to estimate their replacement (rather than historical) cost;
- applying an economic rather than standard accounting approach to depreciation;
- the five-year time period does not capture a full business and investment cycle.

All are considerations, that challenge the implementation and appropriate calculation of any benchmarked profitability measure.

## Issues in relation to interpreting findings and drawing conclusions

The issues that UK Finance can foresee at this early stage are threefold.

Firstly, because of the inherent nature of acquiring it is extremely difficult to robustly quantify the 'capital employed'<sup>3</sup>, as part of any ROCE assessment. The ROCE calculations will be subject to a very wide margin of error and therefore the results will be difficult to interpret and will not be comparable between acquirers. The estimation of WACC is also potentially complex, given the global nature of the businesses. This means that any conclusions (even tentative/draft) on 'excess profitability' need to be treated with great care.

Secondly, any analysis purporting to track the impact of the IFR caps on profitability needs to be considered alongside the changing market conditions that have also occurred during the same timeframe. UK Finance would reiterate that any focus around one particular aspect is too blunt a measure, when attempting to 'pin down'; or, account for the levels of profitability that may have accrued over the chosen timeframe, which has coincided with seismic changes that the acquiring industry has had to respond to, and, further adapt.

Thirdly, a recognition as to what those changing market conditions have been and which should be being reflected and identified in conjunction (e.g. increased card payment penetration at the SME level, significant M&A activity in recent years, seismic and changing customer behavioural trends, massive growth in ecommerce, the exponential growth of online markets / contactless payments, the emergence of a recognised fintech scene characterised by competitive new entrants and international entities now operating at scale in the UK market etc),

Based on the various complexities we have identified we would hope that the PSR takes a flexible approach and is prepared to adapt its analysis should this be required.

Similarly, as has been commonplace with other regulatory investigations, should the methodology prove insufficiently robust, we would respectfully ask that the PSR is responsible enough to disregard and/or discard it as an approach, and, as it chooses to see fit.

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<sup>3</sup> When so much of the value of acquirer's asset bases derives from a variety of intangible assets which are subjective and difficult to quantify.

# Wirecard

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**To:** cards@psr.org.uk

**Subject:** AW: Payment Systems Regulator (PSR) Consultation on our proposed approach to the profitability analysis as part of our market review into the supply of card-acquiring services

Wirecard is in the position to identify and represent the gross profit margin for UK customers. However, we do not have standard reports for the requested customer group based on EBIT and required balance sheet items for determining ROCE.

A wide range of products are based on the Wirecard digital financial commerce platform. For our customers, we build individual solutions to leverage on our ecosystem which is built around digital payments. Therefore the costs for the UK customers are not clearly specifiable. In addition, staff and costs from diverse areas are not automatically graduated.

A determination of the requested positions would be possible only by means of many assumptions, intercompany and cost allocations in the Wirecard group, which would negate the accuracy and validity.

From our point of view, the global gross profit margin has the better informative value, since the platform costs and OPEX/CAPEX are costs you have anyway and, as mentioned above, the sum of the assumptions does not reflect a sharp picture on the ROCE or WACC.

To summarize, due to our wide variety of products, projects and processes, which are reflected in our annual report, a reconciliation on the Wirecard Bank and Wirecard Group Annual Report will not be possible.”

Best regards,



# Worldpay



## PSR market review into the supply of card-acquiring services

Worldpay response to  
profitability analysis consultation  
(MR18/1.6)

5 August 2019

Non-confidential version

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**Note:** Confidential elements of our submission have been redacted and replaced with the [X] symbol.

## 1. Executive Summary

- 1.1 The PSR intends to undertake an assessment of the profitability of providers of card-acquiring services in the context of its market review into the supply of card-acquiring services. On 11 July 2019, the PSR published a consultation paper setting out its proposed approach (the "**consultation document**"). The PSR has indicated that the results from the profitability analysis will form a part of the evidence base used in reaching its view on how competition is functioning.
- 1.2 Worldpay welcomes the opportunity to comment on the PSR's proposed approach to assessing profitability. In section 2 of this response, we have set out our high level comments on the overall approach, in particular we note the following points:
- (a) The type of ROCE analysis suggested by the PSR is complex, resource intensive (for card acquirers and the PSR), and raises numerous practical and methodological difficulties, which are likely to be disproportionate relative to the benefits of this analysis for the PSR's market review. The PSR should not underestimate the complexity of the assessment being proposed and the burden on those card acquirers that are required to provide information for the proposed calculations.
  - (b) Whilst Worldpay understands why a profitability analysis is sometimes undertaken by regulators in a market review/investigation, we have serious concerns as to whether meaningful results can be obtained from this type of analysis in this industry. Worldpay does not consider ROCE to be a suitable metric for assessing the profitability of card-acquiring services, [§]. Particular challenges in reliably estimating ROCE include:
    - (i) intangible assets are significant in this industry, and there is no established basis for them to be accurately quantified;
    - (ii) a large number of significant cost allocation assumptions will be required in order to focus on the PSR's frame of reference, and this will differ by each card acquirer given their different business models;
    - (iii) tangible assets will need to be revalued in order to estimate their replacement (rather than historical) cost, which is a complex and time consuming task;
    - (iv) there are differences between economic and accounting depreciation, which will need to be reflected in the adjustments;
    - (v) the five-year period being considered is too short to consider the full business and investment cycles in this industry and, therefore, the results will not provide an accurate assessment of profitability. However, records of information over longer periods may be less complete or unavailable;
    - (vi) there are significant financial risks, which may also change over time, that reflect an individual card acquirer's appetite towards chargebacks, settlement risk, credit risk and refunds; and

- (vii) the industry has also gone through a period of considerable change and consolidation, which is likely to have affected the costs, revenues and profitability trends of providers of card-acquiring services.
  - (c) The results of the ROCE analysis will be extremely difficult to interpret. This reflects both the number of adjustments that need to be made to the asset base, and the inherent uncertainty of measuring different adjustments, which means the results will have a very wide margin of error. These measurement and interpretation concerns will not be addressed by the PSR's proposed use of a range of values.
  - (d) The results of the ROCE analysis are unlikely to be comparable between card acquirers. However, the parties have very different business models that will need to be taken into account when reaching any conclusions. The PSR's proposed approach also places the burden for making adjustments to ROCE calculations onto the parties, and no guidance has been provided as to how this should be achieved. Stakeholders are therefore likely to apply very different approaches.
  - (e) There are significant challenges to estimating WACC in this industry. [X].
  - (f) Gross profit margins ("**GPMs**") may not provide a reliable basis for assessing profitability between different types of merchants, or for assessing the effect of other goods and services supplied by card acquirers on card-acquiring profitability, as all fixed and common costs are excluded. In addition, GPMs do not take into account any investments that have been made, which will vary significantly between card acquirers. A comparison of GPMs will not, therefore, provide an accurate assessment of the relative profitability of different card acquirers. There are also significant issues raised by using GPMs to assess the impact of the interchange fee caps introduced by the Interchange Fee Regulation ("**IFR**").
  - (g) The PSR's proposed procedure for pursuing this type of profitability analysis is not satisfactory, as it does not give parties sufficient opportunity to comment or engage with the PSR. Parties should be given the opportunity to review the initial outputs of the PSR's analysis in advance of the Interim Report and, in particular, be given the opportunity to respond if any of their adjustments submitted to the ROCE analysis are rejected.
- 1.3 Similar issues to those set out above have previously been raised in relation to the CMA's market investigations into audit services, retail banking, and investment consultants. In each of those cases, the CMA decided not to pursue the initially contemplated ROCE analysis further due to the difficulties identified in measuring ROCE, and the inherent uncertainty of the results. The CMA stated in the investment consultants market investigation that the ROCE analysis would be (i) "*resource intensive for the parties*", (ii) "*disproportionate to attempt to calculate the tangible and intangible asset base*", and (iii) "*unlikely to be robust enough for us to draw any conclusions from it*".<sup>1</sup>
- 1.4 If the PSR decides to persist with its profitability analysis, it should explain in clear and unequivocal terms why it believes these that issues, which have been problematic in other cases, can be overcome in relation to the card-acquiring industry. Unless the PSR addresses these issues in advance of commencing its profitability analysis, Worldpay considers that it is highly unlikely that the results will have the degree of accuracy, or

<sup>1</sup> CMA, [\*Investment consultants market investigation – Appendices\*](#) (2018), paragraph 12 of Appendix A7.

consistency, to inform the PSR when reaching a view on how competition is functioning in the supply of card-acquiring services.

- 1.5 Section 3 of the response provides comments in relation to the PSR's specific questions.

## 2. High level comments

2.1 In this section we set out our high level comments on the PSR's proposed approach to assessing profitability. This section is split into four parts, providing comments on:

- (a) the PSR's approach;
- (b) the appropriateness of ROCE as a measure of profitability;
- (c) the calculation of WACC; and
- (d) the proposed use of GPMs.

### (a) General comments on the PSR's approach

***The PSR is underestimating the complexity and time consuming nature of the task***

2.2 The PSR acknowledges at paragraph 1.17 of the consultation document that there are challenges in conducting a profitability analysis in the card-acquiring industry. It also recognises that, in industries with low levels of tangible assets (such as for card-acquiring), it can lead to results (for ROCE) that are misleadingly high unless various adjustments are made.<sup>2</sup> However, as is clear from the comments set out below, Worldpay considers that these challenges have been significantly understated by the PSR.

2.3 Worldpay does not consider ROCE to provide a meaningful measure of profitability in the card-acquiring industry, [§].

2.4 The type of ROCE analysis suggested by the PSR is complex, resource intensive (for card acquirers and the PSR), and raises numerous practical and methodological difficulties. Conducting this type of analysis typically requires much longer time scales than is envisaged by a market review/study, and requires significantly more engagement with parties than is being proposed by the PSR.

2.5 Worldpay is concerned that this type of analysis will:

- (a) be inaccurate due to the inherent uncertainty in estimating various different aspects of the ROCE calculations (such as intangible assets, revaluing the asset base at the MEA rate, and applying an economic approach to depreciation) for which no guidance has been provided and in respect of which there is no common or agreed approach;
- (b) be undertaken differently by each of the different stakeholders and therefore the results will not be comparable or meaningful; and
- (c) raise serious concerns as to the overall reliability of the results. At the very least the PSR will need to be extremely careful in interpreting and placing any weight on the results, and it will need to apply wide margins of error at various different stages of the calculations, which will compound the overall uncertainty in the calculations.

<sup>2</sup> PSR, [Consultation on the approach to the profitability analysis](#) (MR18/1.6), paragraph 2.7.

2.6 Worldpay considers that the range of issues involved in calculating ROCE, and the complexity of the task, raise serious concerns as to whether meaningful conclusions can be drawn from the results of this type of analysis and, therefore, the proportionality of undertaking the exercise.

2.7 In this regard, Worldpay notes that the CMA decided not to conduct a profitability analysis in the audit, retail banking, and investment consultants market investigations due to the inherent difficulty in calculating the asset base correctly and allocating costs between the different lines of business. As discussed further below, similar issues arise in this case.

***The approach places significant burden on stakeholders, with limited guidance***

2.8 The PSR's suggested approach will place a significant burden on the parties (e.g. to value intangible assets and submit various adjustments in relation to ROCE calculations), which the PSR has said it will review and may (or may not) take into account.

2.9 Worldpay considers that the proposed process for pursuing this type of analysis is not satisfactory, and does not give the parties sufficient opportunity to engage with the PSR. In particular:

- (a) the PSR does not provide any guidance as to how intangible assets should be valued in this sector, or how the other adjustments should be calculated by the parties (see further below);
- (b) the PSR has indicated that the parties will not see the outputs of the profitability analysis, or indeed know whether their submitted adjustments have been taken into account, until the Interim Report;
- (c) the PSR's approach requires the parties to prove a negative (i.e. ROCE will be artificially high, due to the low levels of tangible assets involved in card-acquiring, unless the parties submit detailed analyses to value intangibles, the replacement cost of assets, etc.). Worldpay is concerned that the PSR will decide whether to accept parties' submissions without meaningful engagement with the parties; and
- (d) the PSR has invited proposals for economic adjustments from third parties, although it is unclear from the consultation document on what basis these submissions will be made, or whether card acquirers to whom proposed adjustments relate will have the opportunity to respond accordingly.

2.10 We refer to Worldpay's response to the PSR's consultation paper on cost pass-through, which emphasised the importance of providing stakeholders with an adequate opportunity to engage with the PSR's proposed analyses.<sup>3</sup> We do not repeat those submissions here, except to reiterate the Competition Appeal Tribunal's requirements in *BMI Healthcare* for "fair consultation and the implicit duty on an administrative body to provide an effective opportunity to comment" and the right of a person affected by a decision to be informed of the "gist" of the case which, in competition cases, "will often involve a high level of specificity".<sup>4</sup>

<sup>3</sup> PSR, [Responses to our proposed pass-through analysis](#) (MR18/1.3), paragraphs 2.15-2.20.

<sup>4</sup> [2013] CAT 24, para. 36 and para 39(7). Reference was also made to the CMA's market investigation guidelines and the CMA's principles of transparency and fairness that applies to its work during market investigations.



- 2.11 It is therefore concerning that the PSR has indicated in paragraph 1.18 of the consultation document that the final version of its approach to profitability "*may depart significantly from what we set out here*", whilst at the same time not proposing to engage further with parties prior to the Interim Report. If the PSR is to persist with the type of profitability analysis set out in the consultation document (or a variation thereof), Worldpay considers that it is important that stakeholders are given the opportunity to comment on the results of, and underlying methodology and assumptions used for, the analysis before the Interim Report (i.e. in order to avoid the PSR forming its preliminary conclusions based on an unsound methodology, which have to be amended later in the timetable).
- 2.12 One way to do this would be to establish a data room, so that the parties have visibility of the PSR's preliminary workings (following the CMA's example in both the energy and the aggregates, cement and ready-mix concrete market investigations, which focussed specifically on the CMA's profitability analysis).
- 2.13 As noted above, these steps would be consistent with the PSR's duties to ensure a transparent and fair consultation procedure. In this regard, the CMA's energy market investigation report clearly shows that the parties to that investigation were invited to comment both: (i) on the CMA's approach to assessing profitability, and (ii) its preliminary results, before the provisional findings were published.
- 2.14 The PSR is also proposing to conduct the profitability analysis of card-acquiring services on only five card acquirers in the industry. However, the analysis will have implications for the whole industry, not just the five acquirers identified by the PSR. Other parties in the value chain, as well as other acquirers, should be given enough time and meaningful opportunity to engage with the PSR on its proposed methodology and its findings.
- 2.15 Parties should also be notified in a timely manner if the PSR decides to reject any of their proposed adjustments to the ROCE calculations, and be provided with substantiated reasons for rejecting them. Parties should also have the opportunity to engage with the PSR to refine their submissions and make any necessary adjustments, before the Interim Report is published.

## **(b) Return on Capital Employed (ROCE)**

- 2.16 Worldpay considers that the ROCE approach to assessing profitability in this case raises the following issues:
- (a) ROCE is an unsuitable measure of profitability given the characteristics of the card-acquiring industry;
  - (b) intangible assets are significant in the provision of card-acquiring services and there is no practicable method of accurately quantifying the value of these intangible assets;
  - (c) significant cost allocation assumptions will need to be applied in order to focus on the PSR's frame of reference;
  - (d) tangible assets will need to be revalued in order to estimate their replacement (rather than historical) cost;

- (e) there are differences between economic and accounting depreciation, which will need to be reflected in the adjustments;
- (f) the five-year time period being considered is too short to consider the full business and investment cycles; and
- (g) there are concerns that the ROCE calculations will not be comparable between providers.

2.17 Each of these points is considered in further detail below.

***ROCE is an unsuitable measure of profitability for card-acquiring***

2.18 As mentioned above, one of the measures of profitability that the PSR is considering using is ROCE. The consultation document explains that this will be used to assess: (i) how profitable the supply of card-acquiring services is generally; and (ii) how the profitability of card-acquiring services varies between acquirers.

2.19 However, Worldpay considers that ROCE does not provide a sensible measure of profitability in the card-acquiring industry due to the large proportion of intangible assets involved and the fundamental difficulty in accurately quantifying the total value of capital employed. The analysis will be heavily dependent on assumptions that cannot be validated, which will give rise to a very wide margin of error. As the PSR itself notes, "ROCE relies on complete and accurate asset values for the capital employed component".<sup>5</sup>

2.20 ROCE typically makes more sense as a measure of profitability in industries where:

- (a) the reference market largely coincides with the use of the assets in the business (i.e. to avoid issues around cost allocations);
- (b) the assets are largely tangible and it is relatively easy to estimate their values; and
- (c) where the profile of investment in new assets is relatively consistent over time.

2.21 However, none of the above characteristics apply in the card acquiring industry, which raises significant measurement issues and challenges for conducting this type of analysis.

2.22 [✂]. This means that the PSR's preferred approach for assessing profitability is not reflective of the actual approach adopted by Worldpay.<sup>6</sup> Each of the various components to the ROCE calculation will therefore have to be constructed from scratch, which is likely to be time consuming and introduce the potential for a significant amount of variation and/or error.

<sup>5</sup> PSR, *Consultation on the approach to the profitability analysis* (MR18/1.6), paragraph 2.5.

<sup>6</sup> In contrast, in its market review into the ownership and competitiveness of infrastructure provision, the PSR considered IRR, ROCE and WACC estimates submitted by VocaLink, but these profitability analyses were used in the context of VocaLink's internal benchmarking with European competitors and during contract renegotiations.

***Intangible assets are large and cannot be accurately quantified***

- 2.23 The PSR acknowledges at paragraph 2.7 of the consultation document that in industries with low levels of tangible assets the results of ROCE will "*appear high*" (i.e. profitability will be overstated). The CMA's market investigation guidelines also note that:<sup>7</sup>

*"In industries with a relatively low level of tangible assets, such as service and knowledge-based industries, the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangibles."*

- 2.24 The PSR states, however, that this does not prevent ROCE from being an adequate measure of profitability if undervalued or unrecognised intangible assets are taken into account.<sup>8</sup>
- 2.25 Whilst this is theoretically correct, it fails to recognise that valuing intangible assets is extremely difficult and there is no consistent methodology for doing so. Intangible assets are typically not fully recorded in the financial statements of card acquirers due to accounting conventions. Capitalisation of intangible assets may also involve adjustments to costs (e.g. treating marketing expenditure as a capital expense), which creates an additional source of subjectivity that will impact the ROCE estimates.
- 2.26 Measurement issues become more acute in industries where intangible assets account for a significant proportion of the asset base. This is particularly relevant in the context of card-acquiring services, which is characterised by a high proportion of intangible assets. [X].<sup>9</sup>
- 2.27 In this regard, Worldpay considers that its intangible assets include, but are not limited to, the following:
- (a) extensive customer lists, which provide access to more than 200,000 UK merchants, and many more globally;
  - (b) the extensive relationships that Worldpay has developed with UK merchants over a number of years;
  - (c) the knowledge and know-how in our business in relation to the provision of card-acquiring services (and other card acceptance products more generally);
  - (d) the value of a highly-skilled and specialised workforce;
  - (e) the trust and reputation that Worldpay has established in the card-acquiring industry (i.e. as a high quality and reliable provider of card-acquiring services);
  - (f) the value of the Worldpay brand (e.g. Worldpay is on the "Superbrand" list of recognised UK brands<sup>10</sup>); and

<sup>7</sup> CMA, [Guidelines for market investigations: their role, procedures, assessment and remedies \(CC3\)](#) (2013), Annex 1, paragraph 12.

<sup>8</sup> PSR, [Consultation on the approach to the profitability analysis](#) (MR18/1.6), paragraph 2.7.

<sup>9</sup> [X].

<sup>10</sup> Superbrands, 2019 Business Superbrands (<https://www.superbrands.uk.com/2019-results>).

- (g) the investment in Worldpay's software and proprietary IT systems (i.e. which extends beyond the simple capital cost recorded in its accounts).
- 2.28 The PSR's proposed solution is to require card acquirers to provide a "*robust and evidence-based economic valuation for such intangibles*".<sup>11</sup> However, it is not clear to us that such an approach to valuing intangible assets exists. [§] and we are not aware of any valuation methods that would accurately value the significant intangible assets in the card-acquiring industry.<sup>12</sup> This difficulty is acknowledged in the OECD paper, referred to by the PSR, which explains that "*estimating the MEA of intangible assets is far from straightforward*".<sup>13</sup>
- 2.29 The PSR has not provided any guidance on how it expects card acquirers to value intangible assets, nor has it indicated that it will issue guidance over the coming months. There are therefore significant risks that:
- (a) the approaches adopted by the parties to estimate intangible assets will involve a very large margin of error, such that the ROCE calculations cannot be relied upon to convey any meaningful insight into profitability;
  - (b) the estimates of intangible assets provided by the parties will be rejected by the PSR, although it is clear that if intangible assets are not taken into account in the PSR's analysis, ROCE will be materially overstated; and
  - (c) providers will take different approaches to quantifying the value of intangible assets and therefore arrive at substantially different valuations. This will affect the overall comparability of the profitability data.
- 2.30 The difficulty in valuing intangible assets was one of the key reasons why the CMA decided not to conduct profitability assessments in both the audit and investment consultants market investigations. The CMA noted:
- (a) (in the audit market investigation) that, "*In the case of large professional services firms, much of the asset base is intangible in the form of clients, reputation, human and intellectual capital, and much of this capital (and other types of costs) is shared with other service lines, and we found no reliable way to identify or measure the appropriate costs.*"<sup>14</sup>
  - (b) (in the investment consultants market investigation) that, "*we thought that it would have been very resource intensive, and practically and conceptually difficult, to identify costs relating to the creation of any intangible assets. We considered that it would be disproportionate to attempt to calculate the tangible and intangible asset base... even if we were in a position to calculate the capital base, it was unlikely to be robust enough for us to draw any conclusions from it*".<sup>15</sup>

<sup>11</sup> PSR, [Consultation on the approach to the profitability analysis](#) (MR18/1.6), paragraph 2.7

<sup>12</sup> The intangible assets that are recognised on Worldpay's balance sheet are valued using accounting bases and principles, which are likely to deviate from the true 'economic' value of these assets.

<sup>13</sup> OECD, [Policy Roundtables - Excessive Prices](#) (October 2011), page 395.

<sup>14</sup> Competition Commission, [A report on the provision of statutory audit services to large companies in the UK](#) (2013), paragraph 7.83.

<sup>15</sup> CMA, [Investment consultants market investigation – Appendices](#) (2018), paragraph 12 of Appendix A7.

- 2.31 Whilst Worldpay is open to working with the PSR to establish an agreed approach to valuing intangible assets, Worldpay has serious reservations as to whether this can be achieved with a sufficient degree of accuracy such that it can be relied upon to inform the PSR's conclusions, particularly within the time available for this exercise.

***Cost allocations will be required to focus on the frame of reference***

- 2.32 A further issue that arises in relation to the calculation of ROCE in this case is the allocation of costs and revenue between different lines of business and different geographic areas in order to focus only on the PSR's frame of reference (i.e. the provision of card-acquiring services to UK merchants).
- 2.33 Most card acquirers, including Worldpay, provide a number of different products and/or services in addition to providing card-acquiring services, and provide products and services across a number of different countries. As set out in response to General RFI 1, Worldpay provides a variety of card acceptance and other ancillary services to merchants in the UK, including card-acquiring services for international as well as domestic transactions. For example, Worldpay's Global eCom business provides a wide range of online and mobile multi-currency payment acceptance, validation and settlement services, primarily to internet-led multinationals.
- 2.34 Accordingly, there are assets in the Worldpay business that are used across multiple product lines and geographic areas, and therefore would need to be allocated in order to focus only on card-acquiring services to UK merchants.
- 2.35 The complexity of this task should not be underestimated. The difficulty of correctly adjusting reported figures to focus on the reference market was one of the main reasons why the CMA decided not to conduct a profitability analysis in the audit, retail banking, and investment consultants market investigations. For example, in the retail banking market investigation the CMA concluded that *"there were factors specific to the assessment of profitability in the PCA and SME banking markets which made the originally proposed analysis particularly problematic. These included the appropriate allocation of common and shared costs, equity capital, and revenues"*<sup>16</sup> (emphasis added). The CMA also raised concerns about the comparability of the approaches of different banks: *"each bank uses a range of methods to allocate its shared and common costs, and that each bank's approach to the allocation of shared and common costs would differ depending on its organisational structure, activities, strategy and other business needs... The range of outcomes from an allocation of costs would therefore be extremely wide"*.<sup>17</sup>
- 2.36 There are similar cost and revenue allocation issues that arise in this case. This adds further complexity to the PSR's proposed analysis and raises further doubts as to whether meaningful results can be achieved from a ROCE analysis in this case.

***Assets need to be revalued on an MEA basis***

- 2.37 Under current accounting standards, most assets recorded in the accounts are held at historical (or book) cost. This means that they are valued at the time of purchase.

<sup>16</sup> CMA, [Retail banking market investigation – Final Report](#) (2016), paragraph 2.53.

<sup>17</sup> CMA, [Retail banking market investigation – Final Report](#) (2016), paragraph 2.56.



2.38 As recognised by the PSR, to calculate ROCE it is important that assets are valued on a MEA basis, rather than on the basis of historical costs. This is because the economic value of an asset is typically the value of that asset to the operation of the business (i.e. the opportunity cost or deprival value of that asset), which may be very different to the historical cost recorded in the accounts.

2.39 An MEA approach to valuing assets is the standard approach adopted by the CMA and other regulators when considering ROCE, as it reflects the costs the business would face in replacing those assets. For example, the CMA's market investigation guidelines note:<sup>18</sup>

*"Under current accounting standards, most assets are held at historical cost and this may differ substantially from the 'replacement cost' or 'Modern Equivalent Asset value', which the CC considers to be the economically meaningful measure for its purposes in most cases. In these circumstances, and where this would be likely to have a material effect on its calculations, the CC will consider whether replacement cost values can be derived reliably."*<sup>19</sup>

2.40 The replacement cost of assets (i.e. the MEA value) will usually be higher than the historical cost due to inflation, changes in technology and other factors. Therefore, if ROCE is calculated on the basis of historical costs, it will typically overstate profitability.

2.41 The PSR should not underestimate the complexity of adjusting asset valuations to a MEA basis. Revaluing assets is a complex task that is likely to take time, particularly in the card-acquiring industry, as assets are typically not standardised 'off-the-shelf' products, and do not have readily available list prices. Technological changes are likely to add to the complexity of revaluing the assets at a MEA rate.

2.42 The PSR's proposed solution is to require card acquirers to "fully explain and justify such proposals, including providing supporting evidence and setting out their methodology".<sup>20</sup> In the private healthcare market investigation the CMA instructed external advisors to revalue land values, which took many months to complete. [X] there is significant uncertainty as to how this could be achieved, although it will inevitably require significant time and cost. Without clear guidance from the PSR, there is a real risk that different card acquirers will adopt different approaches to adjusting asset values, which would impact on the comparability of the results.

### ***The difference between economic and accounting depreciation***

2.43 Business assets typically decline in value over time, and depreciation provides a charge (expense) in the accounts for the wear and tear of those assets and reduces the value of the capital employed. Typically, depreciation is applied in the accounts on a straight line basis over the assumed life of the asset. However, the assumed asset life and the speed of the depreciation in the accounts may be different to the actual economic life of those assets, which can have significant impact on the ROCE calculations.

<sup>18</sup> CMA, [\*Guidelines for market investigations: their role, procedures, assessment and remedies \(CC3 \(Revised\)\)\*](#) (2013), Annex A, paragraph 14.

<sup>19</sup> The Competition Commission's previous market investigation guidelines (CC3) also stated that "*the Commission will normally consider returns on the depreciated replacement cost of assets*" (emphasis added).

<sup>20</sup> PSR, [\*Consultation on the approach to the profitability analysis\*](#) (MR18/1.6), paragraph 2.10.

- 2.44 Financial accounts often assume a conservative approach to depreciation (i.e. assuming assets lives that are shorter than the actual economic life of assets). This can result in assets that are still in use (and therefore have an economic value) despite being fully depreciated in the financial accounts.
- 2.45 If the actual economic life of an asset exceeds the asset life assumed for the purposes of applying depreciation in the financial accounts, the capital base will be understated (and therefore the ROCE overstated). It is important therefore that the PSR takes this into account when considering the adjustments proposed by card acquirers.

***A five-year period is too short to accurately assess profitability***

- 2.46 The PSR is proposing to assess ROCE over a five-year period from 2014 to 2018. However, there is a risk that the results of ROCE will not provide an accurate assessment of profitability as: (i) it does not cover the full business cycle; and (ii) it does not cover the full investment cycle.
- 2.47 In relation to (i), it is important that any assessment of profitability takes account of long term trends, and in particular the impact of the full business cycle. The OECD paper which the PSR refers to acknowledges that "*we need to look at longer term patterns of profitability, ideally over the length of an economic cycle.*"<sup>21</sup> This is particularly relevant in relation to card-acquiring services, as transaction volumes and card-acquiring revenues would tend to be higher during periods of economic growth and high consumer spending, and lower during periods of economic downturn or recession. Moreover, as explained below, periods of economic decline are typically associated with higher rates of chargeback and business failure, which may give rise to additional underwriting costs for card-acquirers. The period 2014 to 2018 only captures a period of growth and, therefore, we would reasonably expect card-acquiring revenues to be higher on average than if assessed across the business cycle as a whole.
- 2.48 The five-year period under consideration will also raise issues with regard to the full investment cycle of the assets (i.e. certain assets last well in excess of five years). This is likely to give rise to a misleading picture of profitability, particularly where up-front investment costs have been incurred or the programme of investment is "lumpy", as is the case for card-acquiring services. This means that there are likely to be significant variations in the capital base depending on the programme of investment and the stage of the investment cycle, which could give rise to erroneous conclusions as regards the level of profitability. [X].
- 2.49 Accordingly, if the PSR were to pursue its proposed ROCE analysis, Worldpay would urge it to be wary of relying on results which only considers a partial business cycle and a partial investment cycle, and which may therefore not provide an accurate assessment of profitability. Whilst Worldpay is not suggesting that the PSR undertakes its analysis over a longer period ([X]), it is important that these factors are taken into account when interpreting the results of the analysis.

***ROCE must also be adjusted to reflect underlying risks***

<sup>21</sup> OECD, *Policy Roundtables - Excessive Prices* (2011), page 390.

- 2.50 The consultation document does not explain how the PSR's assessment of ROCE will take into account the risks that acquirers assume when providing card-acquiring services.
- 2.51 For example, under card scheme rules, the card acquirer is accountable for certain financial losses of a cardholder (e.g. in the case of fraudulent payments made on a stolen card, or a merchant not honouring its obligations to the issuing bank). This process is managed by way of chargebacks. In addition to chargeback risk, card acquirers must also assume settlement risk, credit risk and refund risks. Any assessment of ROCE must take into account the risks that are faced by the individual card acquirer providing the card-acquiring service, which may impact the overall level of profitability observed in any particular period (i.e. the returns reflect the risks taken). The risks, and the returns, are likely to vary from year-to-year (e.g. chargebacks and business failures tend to be higher during economic downturns and recessions).
- 2.52 In addition, as previously explained to the PSR, there are large variations in risk assumed by card acquirers, both between lines of business but also between different merchants within the same line of business. Worldpay ensures that risk exposure is managed in a structured and disciplined manner and kept within both the requirements of the card schemes and Worldpay's risk appetite parameters and limits. However, risk is a complex process, and different acquirers are likely to have different risk profiles depending on the sectors and merchants that they serve, and their overall risk appetite. Unless the differences in risk are adequately controlled for, the ROCE analysis may not be comparable between acquirers (i.e. differences in ROCE may reflect differences in levels of risk-taking).

***ROCE may not be comparable across card acquirers***

- 2.53 The PSR is proposing to use ROCE to compare the profitability of card-acquiring services between the five acquirers that are the focus of the profitability analysis. However, the five acquirers chosen by the PSR all have very different business models and corporate strategies, and therefore ROCE estimates may not be comparable.
- 2.54 It is not apparent to Worldpay which are the "*five largest acquirers supplying UK merchants*" in relation to which the PSR intends to conduct its profitability analyses. In any case, as Worldpay has previously outlined in response to Question 19 of General RFI 1, there are significant differences in the business models of UK card acquirers. These include not only differences in the size and focus of card acquirers within different merchant segments, but also the different product offerings within, and outside of, the payments industry and across multiple geographic regions. For example:
- (a) two of the largest card acquirers are also major card-issuers in the UK and, therefore, earn revenues from both card-acquiring services and card-issuing services. This also enables them to offer "on-us transactions" that are not authorised and cleared through the card payment system;
  - (b) two of the largest card acquirers belong to corporate groups that also provide retail banking services to businesses. Therefore, they are capable of foregoing revenues in card-acquiring services in order to invest and develop, potentially more profitable activities, through the provision of retail banking services;



- (c) card acquirers generally provide different services (or levels of service) across the card acceptance value chain, including within card-acquiring services. For instance, some card acquirers predominantly recruit merchants using in-house sales teams, whereas others rely heavily on referral relationships with ISOs;
  - (d) each card acquirer has a different approach to the provision of card-acceptance products, which are likely to share fixed and common costs with card-acquiring services. For instance, some card acquirers have partnered with technology providers for the provision of mPOS devices, whereas other card acquirers (such as Worldpay) have developed, piloted and launched their own;
  - (e) each card acquirer has a different mix of merchants, which may include a disproportionate number of smaller or larger merchants, which will impact on the level of capital employed for providing card-acquiring services;
  - (f) as explained above, each card acquirer will have a different appetite to chargeback risk, settlement risk, credit risk and refund risk. Therefore, in periods of growth and/or economic stability, card-acquirers assuming greater risks might expect higher returns;
  - (g) each card acquirer offers a different eCommerce proposition, with significant variance in merchant size. For example, Worldpay competes with global eCommerce providers such as Adyen and Chase Merchant Services to provide card-acquiring services to multi-national corporate merchants, whereas other card acquirers in the UK focus predominantly on domestic businesses; and
  - (h) in general terms, each card acquirer has a different wider business portfolio within, and outside of, the payment acceptance value chain. For example, some card acquirers are international leaders in payments technology, whereas others are financial institutions with hundreds of billions of pounds in assets under management.
- 2.55 The PSR has not explained how it intends to account for these differences when drawing comparisons between ROCE calculations for each card acquirer. Moreover, as set out above, the PSR is requiring stakeholders to undertake significant work in making adjustments to their own financial records, and it is not clear how the PSR intends to reconcile these and ensure consistency.

### (c) Weighted Average Cost of Capital (WACC)

- 2.56 The PSR is proposing to compare its estimate of ROCE against reasonable values for the Weighted Average Cost of Capital (WACC). We agree that the WACC is a sensible benchmark against which to compare ROCE in principle. However, estimating a WACC specific to the PSR's frame of reference will be a complex exercise for a number of reasons, considered further below.

#### ***It is difficult to estimate a WACC specific to card-acquiring for UK merchants***

- 2.57 The PSR is planning to estimate a ROCE in relation to the supply of card-acquiring services to UK merchants. In order to ensure consistency, it should compare the estimated ROCE against a WACC estimate that is also specific to the supply of card-

acquiring services to UK merchants. However, Worldpay considers that it will be extremely difficult to estimate a WACC on such a narrow basis.

2.58 [X].

2.59 Moreover, as there are no providers that focus exclusively on the supply of card-acquiring services to UK merchants, the PSR will be unable to use another card acquirer as a basis for measuring the WACC. As noted above, there are significant differences between UK card acquirers in terms of their focus on different merchant segments, product offerings and geographic regions. Different card acquirers will therefore have different risk profiles and different capital structures which will affect their WACC.

***It is not appropriate to compare the WACC to other regulated industries***

2.60 The PSR plans to establish a range for the WACC by drawing on relevant evidence, including evidence from other regulated sectors. However, Worldpay does not consider it appropriate to compare the WACC relevant to card-acquiring services to UK merchants with the WACC in other regulated industries, which will have very different risk factors, gearing ratios, and financing costs.

2.61 Moreover, the PSR should be cautious when applying standard parameters that have been estimated in other sectors. Although some inputs to the WACC, e.g. the risk-free rate, can be applied across sectors, most inputs to the WACC are sector-specific and may be significantly different for the supply of card-acquiring services.

2.62 In particular, it will be important for the PSR to give careful consideration to: (i) the equity beta; (ii) the cost of debt; and (iii) gearing ratios, all of which are likely to be different for card-acquiring services compared to other regulated industries.

***The use of an average industry wide WACC across time***

2.63 The PSR plans to "compare ROCE against a range of reasonable values for WACC".<sup>22</sup> However, the PSR has not set out how it plans to estimate this range. In particular, the PSR has not indicated whether it plans to consider:

- (a) an industry wide WACC or a firm specific WACC. Worldpay considers that it would be misleading to consider an average industry wide WACC, as there are significant differences between card acquirers (as set out above); and
- (b) an average WACC over a five-year period. Worldpay considers that it is important for the PSR to consider how the WACC has changed over the period 2014 to 2018. Considering an average WACC over the five-year period could mask any annual variations in the WACC.

2.64 It is important that the PSR takes these considerations into account when estimating a range of reasonable values for WACC against which to compare ROCE.

2.65 Moreover, as explained above, card acquirers are exposed to significant financial risk in terms of chargebacks, settlement risk, credit risk and refunds. This systematic risk should be reflected in the estimation of the equity beta and any differences in risk profiles between

<sup>22</sup>

PSR, [\*Consultation on the approach to the profitability analysis\*](#) (MR18/1.6), paragraph 2.17.

card acquirers also needs to be considered (e.g. due to the type of merchants that they serve).

### ***Assessing systematic risk - estimating the equity beta***

- 2.66 A key input to the WACC is the equity beta (i.e. a company's volatility relative to the wider market), which is also known as systematic risk. The PSR will need to estimate an equity beta specific to card-acquiring services to UK merchants. However, as noted above there are no providers that focus exclusively on the supply of card-acquiring to UK merchants. Therefore there are unlikely to be any companies that will provide a reasonable proxy of the systematic risk facing providers of card-acquiring services to UK merchants.
- 2.67 It is not appropriate to assume that the equity beta for Worldpay, or any of the other UK card acquirers, provides an appropriate measure of systematic risk. As noted above, all UK card acquirers have diversified businesses in terms of the products and services they provide and the geographies they serve. The diversified nature of these businesses means that the systematic risk facing card acquirers is likely to be significantly lower than the systematic risk facing a company focussed exclusively on providing card-acquiring services to UK merchants.
- 2.68 Therefore, the PSR will need to take significant care estimating the equity beta, and it should consider whether an upward adjustment will be necessary to correct for a higher systematic risk facing a company focussed exclusively on providing card-acquiring services to UK merchants.

### **(d) Gross profit margins (GPMs)**

- 2.69 The PSR intends to rely upon GPMs to answer two of the five questions that its profitability analysis seeks to address. These are:
- (a) how the profitability of card-acquiring services vary across broad types of merchant; and
  - (b) how variations in the profitability of card-acquiring have changed over time, in particular following the introduction of interchange fee caps under the IFR.
- 2.70 The PSR also states in paragraph 2.24 of the consultation document that it is considering whether to use "*GPM for comparisons between acquirers*".
- 2.71 However, for the reasons set out below, Worldpay considers that GPMs do not provide a reliable or appropriate measure for the purpose of answering the questions set out above, or for making comparisons between card acquirers.

### ***GPMs cannot be compared across different merchant groups***

- 2.72 The PSR's definition of GPM in paragraph 2.21 of the consultation document includes revenue minus "*direct selling costs and other relevant direct costs*". In other words, the measure excludes all fixed and common costs, and does not take account of any investments that have been made.
- 2.73 However, the allocation of fixed and common costs is typically not symmetric across merchant types. The cost of recruiting, onboarding and servicing a merchant throughout

its relationship with Worldpay will to a significant extent vary depending on whether that merchant is, for example, a sole trader processing relatively few card-present transactions at a single site or a national retailer with multiple site-locations and a significant online presence. In this regard, SME merchants typically face a disproportionate amount of fixed and common costs relative to their transaction volumes.

- 2.74 Unless all fixed and common costs are taken into account, and allocated correctly between different types of merchant, any comparison between types of merchant will be subject to error. Whilst the PSR states at paragraph 2.22 of the consultation document that this approach "*avoids much of the complication of the overhead and common cost allocations*", it fails to recognise that by excluding these costs, it is unlikely to provide a reliable basis for comparing the profitability between different merchant types, or over time.

***Using GPM to assess the impact of interchange fee caps will be misleading***

- 2.75 As noted above, the PSR states that it intends to use GPMs to examine the impact of interchange fee caps introduced under the IFR. However, this approach raises a number of potential issues.
- 2.76 First, GPMs do not necessarily provide a reliable basis on which to identify patterns of profitability across different periods of time. In particular, the PSR has not explained how it intends to distinguish between changes in GPM resulting from interchange fee caps under the IFR, and any other conceivable reason that a card acquirer's GPM may have changed during the same period. [§].
- 2.77 In general terms, GPM may vary for a number of reasons, such as to reflect different phases within a card acquirer's investment cycle, and changes in corporate strategy. For example, a card acquirer may introduce strategic changes in response to new demand or changing merchant behaviour, or as a result of corporate restructuring. The introduction of interchange fee caps must also be distinguished from scheme fee increases and changes in other costs that applied during the same period. The PSR's methodology does not indicate whether, or indeed how, adjustments would be made to separate the impact on GPM of such changes from the introduction of interchange fee caps under the IFR.
- 2.78 Second, the consultation document would appear to suggest that the introduction of interchange fee caps was a single, isolated event. In paragraph 1.15 of the consultation document, the PSR states that the five-year period it has proposed for its GPM analysis "*straddles the introduction of interchange fee caps in the Interchange Fee Regulation in December 2015*", but the impact of interchange fee caps cannot be confined to the entry into force of legislation.
- 2.79 In practice, for certain types of transactions, the main scheme operators were already providing lower interchange fees due to scheme operator commitments offered to the European Commission in February 2014, which became legally binding on 1 January 2015. [§].
- 2.80 As a result, the basis of comparison for the pre-IFR scenario is confined to a single calendar year (2014), which does not provide a sufficiently long or reliable period before the IFR came into effect to be used as a benchmark.
- 2.81 Third, GPMs also fail to take account of any investment in quality or service that has taken place and is not a relevant direct cost (as explained in Worldpay's consultation response

on cost pass-through, pass-through of lower interchange fees can take place in a number of ways, and is not limited to changes in price). By overlooking such investments in quality and service, GPMs are unlikely to provide a reliable basis to assess the impact of interchange fee caps under the IFR.

***It is inappropriate to compare GPMs between card acquirers***

- 2.82 Despite the PSR recognising that there may be inconsistencies between how card acquirers classify cost items, the PSR states that it is considering using GPMs to make comparisons between card acquirers.
- 2.83 Worldpay does not consider that a comparison of GPMs between card acquirers would be meaningful, and there is a risk that it could lead to erroneous conclusions being reached. This is for the following reasons:
- (a) as mentioned above, the GPM measure excludes all fixed and common costs, and does not take account of any investments that have been made, all of which will vary significantly between card acquirers. A comparison of GPMs will not therefore provide an accurate assessment of the relative profitability of different card acquirers;
  - (b) a comparison of GPMs will fail to take into account the different business models of card acquirers (e.g. a card acquirer that has invested significantly in the quality of its card-acquiring service may expect to have a higher GPM than an acquirer that provides a low cost/low quality service). In these circumstances, it would be wrong to suggest that one business model is preferred over the other purely on the basis of a comparison of GPM;
  - (c) GPMs may vary from year-to-year (and for different card acquirers) for a number of reasons, such as to reflect different phases within a card acquirer's investment cycle, and changes in corporate strategy. There are numerous reasons to explain variations in gross margins which are unrelated to the PSR's objectives in this case; and
  - (d) as recognised by the PSR, different card acquirers are likely to record cost items in different ways, and therefore there is no meaningful way to make comparisons. For example, Worldpay and Barclaycard have each invested in sales teams dedicated to the recruitment, on-boarding and retention of merchants. In contrast, Worldpay understands that some of its other competitors rely heavily on referral relationships with ISOs to recruit merchants, which could impact on the way costs are recorded.
- 2.84 If the PSR does decide to pursue a comparison of GPMs between card acquirers, Worldpay would request that the card acquirers are notified of this decision, and that they are given the opportunity to make representations well in advance of the Interim Report.

**Other goods and services**

- 2.85 The PSR states in paragraph 1.12 of the consultation document that it also wants to understand the impact of the other goods and services supplied by card acquirers (which are described as including POS terminals, payment gateways, cash advances and data analytics) on the profitability of card acquirers, and how they impact on the profitability of card-acquiring services more generally.

- 2.86 The PSR states in paragraph 2.31 of the consultation document that it will consider revenue and gross profits in measuring the profitability of the other goods and services that are supplied.
- 2.87 Worldpay is concerned that this approach may significantly overstate the profitability from supplying these products, as it fails to recognise that:
- (a) there are fixed and common costs that should be attributed to supplying these products (e.g. sales teams, building costs, etc.). It would be inaccurate to assume that all common and fixed costs are attributed only to the provision of card-acquiring services; and
  - (b) there are often significant upfront investment costs in developing these products (e.g. investment in payment gateways, data analytics, etc.) which must be recouped. Neither of the proposed measures will have any appreciation for the investment undertaken.
- 2.88 Accordingly, it is insufficient to examine revenue and gross profitability for other goods and services, without also considering the fixed and common costs involved, and the investment undertaken (which may vary by type of product).
- 2.89 Worldpay would also note that the GPMs calculated on other goods and services will not be comparable between products or with the provision of card-acquiring services more generally. Accordingly, to the extent that PSR intends to use this metric to draw comparisons, there is a risk that it could lead to erroneous conclusions being reached.



### 3. Responses to consultation questions

**Question 1:** Do we have the right objectives for our profitability analysis, given the aim of this market review?

**Question 2:** Have we selected suitable measures of profitability, given our objectives?

- 3.1 The objectives set out in the consultation document are fairly standard for the type of profitability analysis being proposed. In particular, the PSR has noted at paragraph 1.4 that its profitability analysis will help it to "*understand how competition is functioning*". As recognised by the PSR in paragraph 1.7, evidence on profitability needs to be considered alongside other evidence on how competition is functioning. It is also important that the PSR remains mindful that "*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*".<sup>23</sup>
- 3.2 Moreover, the PSR should give due regard to the appropriateness of undertaking a profitability analysis in an industry characterised by innovation and disruption, where markets cannot be understood solely by reference to the current state of competition. Accordingly, the CMA recently assessed competition in relation to the supply of mPOS and omni-channel services by focussing on "*the likely impact on competition as it is expected to develop*".<sup>24</sup>
- 3.3 Notwithstanding the above, the main issue for the PSR to consider is whether the proposed approach to assessing profitability is suitable to inform those objectives, given the characteristics of this particular market. Whilst the PSR acknowledges that there are challenges in conducting a profitability analysis, Worldpay considers that it has significantly underestimated the complexity of the task in this case (paragraphs 2.2 to 2.7 above).
- 3.4 Worldpay does not consider that ROCE provides a meaningful measure of profitability in the card-acquiring industry, [§] (paragraphs 2.18 to 2.22 above). The adjustments that need to be made (e.g. to value intangibles, revalue the asset base to reflect MEA values, allocate costs to focus on frame of reference, adopt an economic approach to depreciation, etc.) are complex, resource intensive (for card acquirers and the PSR), and raise numerous practical and methodological difficulties (paragraphs 2.23 to 2.45 above). As noted above, the CMA has decided not to conduct a ROCE analysis in a number of cases due to similar difficulties arising.
- 3.5 Worldpay has serious concerns as to whether reliable results can be obtained from this type of ROCE analysis to inform the proposed objectives. This is due to: (i) the difficulty of measuring the various different adjustments that would need to be made, which points to a very wide margin of error (and which is compounded by the number of adjustments that need to be made); and (ii) the likelihood of different card acquirers adopting different approaches, so that the results are not comparable.
- 3.6 Similar issues arise in relation to the PSR's proposed use of GPMs. Again, the concern is whether GPMs are a suitable metric to inform the objectives set out in the consultation

<sup>23</sup> PSR, [Consultation on the approach to the profitability analysis](#) (MR18/1.6), paragraph 1.17.

<sup>24</sup> CMA, [Completed acquisition by PayPal Holdings, Inc. of iZettle AB – Final report](#) (2019), paragraph 10.

document. As GPMs exclude all fixed and common costs from the analysis, it is unlikely to provide a reliable basis for assessing profitability (i) between different types of merchants (paragraphs 2.72 to 2.74 above), or (ii) for the supply of other goods and services (paragraphs 2.85 to 2.89 above), as proposed by the PSR. It is also unlikely provide a reliable basis for assessing the impact of interchange fee caps introduced by the IFR over time (paragraphs 2.75 to 2.81 above).

- 3.7 Accordingly, relative to the level of time and resource required to carry out the proposed profitability analysis, Worldpay considers that it is unlikely to have the degree of accuracy, and consistency in approach amongst acquirers, such that it will be informative to support the PSR reaching a view on how competition is functioning in the supply of card-acquiring services.

**Question 3:** 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?

- 3.8 Although the use of the WACC as a benchmark for comparing ROCE is a fairly well established approach, the PSR has not provided details as to how it will estimate a range of values for WACC suitable for comparison. Estimating a WACC that is specific to the PSR's frame of reference will be a complex exercise for a number of reasons:
- (a) [REDACTED] (paragraph 2.58 above);
  - (b) other card acquirers are unlikely to use internal WACC estimates based on the PSR's frame of reference, because they do not provide card-acquiring services exclusively on this basis (paragraph 2.59 above). In any case, this is not a suitable proxy for calculating Worldpay's WACC, because of differences between their business models (paragraph 2.54 above);
  - (c) other regulated industries are not a suitable proxy for Worldpay's WACC, because those industries have different risk factors, ratios and financing costs. Using a WACC from a different sector is likely to compound error-margins even further (paragraphs 2.60 to 2.62 above); and
  - (d) inputs for calculating WACC, such as the equity beta, cannot be estimated based on other card acquirers (which each have diversified businesses) or other industries (which provide no meaningful basis of comparison) (see paragraphs 2.66 to 2.68).
- 3.9 As set out above, an industry-wide WACC would not be appropriate because it fails to take into account the significant differences between the business models of card acquirers, and the PSR should also look at the annual variation in WACC rather than just relying on a five-year average (paragraphs 2.63 to 2.64).
- 3.10 The PSR has not proposed to benchmark GPMs in the consultation document, although it does intend to draw comparisons of GPMs (e.g. over time, between types of merchants, and possibly between card acquirers). Worldpay does not consider that there would be a meaningful basis for benchmarking GPMs, and the PSR should be extremely cautious in attempting to make such comparisons (paragraphs 2.72 to 2.84).



**Question 4: Have we identified all the material types of adjustment to data?**

- 3.11 The consultation document explains that a combination of scope and economic adjustments may be necessary to ensure that accounting data used to inform the PSR's profitability measures are relevant and representative. Without appropriate adjustments, the PSR acknowledges that the calculation of ROCE may lead to results that "*appear high*", particularly for businesses with relatively low levels of tangible assets.
- 3.12 Whilst the consultation document identifies a number of "*material types of adjustment*" in broad and general terms (each a universal consideration to any ROCE analysis), it provides no guidance as to how, in practice, those adjustments should be made. It places that burden solely on card acquirers. The PSR also provides limited insight into the standard against which it will assess proposed adjustments (save that respondents must "*fully explain and justify their choices*", which must be "*justified by objective evidence and robust economic arguments*"). That lack of guidance is compounded by the lack of meaningful opportunity to engage with the PSR during the process, as set out more fully in paragraph 2.9 above.
- 3.13 Worldpay has set out in this response a number of additional considerations and potential issues that might give rise or relate to necessary adjustments, which include:
- (a) intangible assets are significant in this sector and there is no established basis for them to be accurately quantified (paragraphs 2.25 to 2.31);
  - (b) a large number of significant cost allocation assumptions will be required in order to focus on the PSR's frame of reference, and this will differ by card acquirer given their different business models (paragraphs 2.32 to 2.36);
  - (c) tangible assets will need to be revalued in order to estimate their replacement (rather than historical) cost, which is a complex and time consuming task (paragraphs 2.37 to 2.42);
  - (d) there are differences between economic and accounting depreciation, which will need to be reflected in the adjustments (paragraphs 2.43 to 2.45);
  - (e) the five-year period being considered is too short to consider the full business and investment cycles in this industry, and therefore the results will not provide an accurate assessment of profitability. However, records of information over longer periods will be less complete or not available (paragraphs 2.46 to 2.49);
  - (f) there are significant financial risks, which may also change over time, that reflect an individual card acquirer's appetite towards chargebacks, settlement risk, credit risk and refunds (paragraphs 2.50 to 2.52); and
  - (g) ROCE may not be comparable between card acquirers due to the different business models and corporate strategies adopted. In order to draw meaningful comparisons between different card acquirers, it would be necessary to ensure that all adjustments are made on a consistent basis (paragraphs 2.53 to 2.55).
- 3.14 The results of the ROCE analysis will therefore be difficult to interpret. This reflects both the number of adjustments that need to be made, and the inherent uncertainty of

measuring the various different adjustments, which means the results will have a very wide margin of error. These measurement and interpretation concerns will not be addressed by the proposed use of a range of values.

- 3.15 As noted above, [X]. Worldpay therefore reserves its right to submit further representations in relation to adjustments that it might encounter whilst engaging with the PSR throughout this process. Parties should have the opportunity to engage with the PSR to refine their submissions and make the necessary adjustments before the Interim Report is published.

**Question 5:** Will our proposed process be adequate to generate a reliable analysis, given our objectives?

- 3.16 Worldpay has provided explanations throughout this response as to why it has concerns that the PSR's proposed methodology will not generate a reliable analysis. A high-level overview is provided at paragraph 1.2 of the Executive Summary.
- 3.17 The concerns relating to the PSR's methodology are compounded by inadequacies in the procedural steps that the PSR is proposing for consulting with the card payments industry. In particular:
- (a) the PSR did not consult on whether to undertake a profitability analysis in the draft terms of reference published in July 2018, and this public consultation document is the first time that Worldpay has been invited to comment on the PSR's proposal to undertake such a significant and resource-intensive exercise;
  - (b) the PSR has not provided any guidance on cost allocation or revaluation in its consultation document. We understand that such a document will accompany the PSR's forthcoming information requests, and respectfully invite the PSR to request comments from Worldpay and other parties on a draft version of that guidance document in advance;
  - (c) the PSR has indicated that it does not intend to publish any further documents between this consultation document and its Interim Report. This is highly unsatisfactory, as parties will not have the opportunity to engage with the PSR as it develops its analysis; and
  - (d) the PSR has not confirmed whether key relevant parties to this market review will be granted access to a data room, in order to conduct their own analyses and/or verify the PSR's modelling.
- 3.18 By not providing parties with a full opportunity to engage with the PSR's profitability analysis, there is an even greater risk that the results published by the PSR in the Interim Report will not be subject to rigorous scrutiny, which may ultimately have implications on the appropriateness of any proposed remedies.
- 3.19 Finally, in addition to considering whether its proposed process is "adequate" (i.e. sufficient), the PSR should also consider whether undertaking a profitability analysis is proportionate (i.e. necessary), in the light of the objectives of the PSR's market review. As explained in response to Question 1, there are significant issues impacting the

meaningfulness and reliability of the PSR's proposed methodology that, in turn, limit the probative weight of any conclusions that may be drawn from that analysis. The potential value of the evidence obtained should be weighed against the significant practical and resource-implications that profitability exercises invariably involve, particularly in industries where difficulties arise due to cost allocations and the need to measure significant intangible assets. It is unsurprising in these circumstances, as explained above, that the CMA has previously decided not to conduct profitability analyses following its initial consultation with parties during market investigations, even taking account of the longer timeframes of those processes.