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To
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Commerce Commission

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Dear David, Nicola, Gavin, and Harry

Ingenico/Paymark: submission on behalf of Verifone on the letter of issues

1. We are making this submission on behalf of Verifone.

2. Verifone agrees with the vast majority of the preliminary views that the Commerce Commission has set out in its letter of issues on Ingenico Group SA's application for clearance to acquire Paymark Limited, dated 11 July 2018.

3. Verifone has already made submissions and provided information to the Commission about a number of the matters identified in the letter of issues. This submission responds to the preliminary views expressed in the letter of issues in relation to market definition, the counterfactual, and the merged entity's ability and incentive to foreclose competition in terminals and digital payment markets, as well as the likely effect of any foreclosure on the level of competition for payment solutions.

4. We do not repeat in full detail the submissions Verifone has already made on those issues. The focus of this submission is on matters relating to:

   (a) the degree of substitutability between S2I and S2A transactions;

   (b) the ability of Verifone to effectively respond to any foreclosure strategy pursued by the merged entity by building its own issuer links;

(c) the ability and incentive of banks to exercise countervailing power to prevent adverse competition effects that might result from a foreclosure strategy; and

(d) the extent to which growth in emerging payment methods could counteract any lessening of competition that might result from a foreclosure strategy.

Market definitions

Markets for the supply of terminals and digital payment services

5. Verifone agrees with the view the Commission has expressed in paragraph 15 of the letter of issues, that concerns about the effect of the proposed transaction on the supply of terminals could affect terminal suppliers in both the wholesale terminal market and retail terminal markets.

The market for switching services: the degree of substitutability between S2I and S2A transactions

6. In paragraphs 16 to 23 of the letter of issues, the Commission considers the degree to which S2I and S2A transactions are substitutable.

7. Verifone submits that, contrary to Ingenico's submissions, the two types of payments are not substitutable from the demand side. Alternatively, if there is any degree of substitutability between the two types of transactions, that substitutability is one-sided. That is, from many merchants' perspectives, S2I transactions may be acceptable substitutes for S2A transactions, but not vice-versa.

8. The main reason for this is the different level of cost that merchants incur when they accept each type of transaction. S2I transactions are largely free from a merchant's perspective. On the other hand, merchants are required to pay fees for each S2A transaction they accept. Depending on the merchant and on the particular transaction, the fee for an S2A transaction can account for a significant portion of the margin that would otherwise be available to the merchant.

9. According to the 2018 Retail NZ Payments Survey Report,[1] average merchant fees in New Zealand as a proportion of transaction value are:

(a) 0% for domestic eftpos S2I transactions;

(b) for S2A transactions:

(i) 1.2% for contactless debit transactions; and

(ii) 1.6% for credit transactions.

10. The high fees that merchants are required to pay to process S2A transactions mean that many merchants are unlikely to see S2A transactions as substitutes for S2I transactions. The fees are likely to make merchants resistant to being steered towards accepting more S2A transactions. For example, Burger King recently announced that it will no longer accept contactless payments (a form of S2A payment), because of the associated fees. To provide an acceptable offering to merchants,

[1] Available at http://www.retail.org.nz/advocacy/payments.

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a switch needs to be able to process S2I transactions. This is consistent with the fact that around 20% of merchants in New Zealand do not accept any S2A transactions.

11. The price differential for S2A and S2I transactions would provide the merged entity with a buffer to increase the costs of rival switches that rely on access to Paymark's network to process S2I transactions as well as Paymark's S2I fees for its own merchant customers, without risking merchants moving to a rival switch that would force the m to accept more S2A transactions.

12. Retail New Zealand may be in a position to provide the Commission with further information about the degree to which merchants might be willing to accept a payment solution under which they would be forced to process a higher proportion of S2A transactions than currently.

Counterfactual

With the merger

13. As Verifone has previously submitted, Paymark has already been engaging in behaviour in the switching market to make it more difficult for its rivals to compete. Examples include:

    (a) **[**
    REDACTED
    ]; and

    (b) the **[**
    REDACTED
    ].

14. Verifone remains of the view that, with the proposed transaction, the merged entity would have clear incentives to extend that type of behaviour into other markets (being the terminals and digital payment markets) in which it will have an interest. That incentive would only be reduced if there is some way for merchants to avoid relying Paymark's switch to process transactions. For the reasons outlined in the *Foreclosure* sections of this submission, that will not be the case.

15. In addition, the prospect of being able to foreclose competition in other markets will strengthen the merged entity's incentives to engage in anticompetitive behaviour in the switching market, compared with Paymark's (already strong) incentives. If the merged entity were to allow the presence of a rival switch that could offer switching services to merchants on reasonable terms, that would threaten the merged entity's ability to successfully foreclose competition in downstream markets. Accordingly, the merged entity would have a strong incentive to further restrict rival switches' access to Paymark's network for the processing of S2I transactions, resulting in a lessening of competition in the provision of switching services to merchants. As Verifone has informed the Commission, **[**
REDACTED
].

16. Verifone has previously submitted about its concerns regarding non-solicitation clauses, volume commitments, and associated financial incentives that it understands have been included in either the sale and purchase agreement for the proposed transaction, or service agreements ancillary to the proposed transaction. Verifone understands that those arrangements are contingent on the proposed transaction proceeding.

17. Verifone does not have any new information about the arrangements, and the Commission remains in a better position than Verifone to assess the likely effects on competition. Verifone remains concerned about the incentives those arrangements might create for the vendor banks to retain transaction volume on the Paymark switch, and the disincentives they might create for the vendor banks to respond to anti-competitive behaviour by the merged entity.

Without the merger

18. Verifone agrees with the Commission's preliminary views that:

    (a) there is a real chance that, without the proposed transaction, Paymark may continue under its current ownership structure, or may be sold to an alternative purchaser without a presence in the New Zealand terminals, digital payments, or switching markets; and

    (b) no matter which of those two counterfactuals is adopted, the most important feature of the competition analysis is that the proposed transaction will result in Paymark becoming a vertically integrated entity with incentives to maximise its profits across all of the markets in which it participates, rather than just in the provision of switching services.

Foreclosure: will the merged entity have market power?

19. Verifone agrees with the preliminary view the Commission expresses in paragraph 57 of the letter of issues that the merged entity will have significant market power for the supply of switching services. In particular, Verifone's ability to compete with Paymark for the provision of switching services to merchants is limited to ANZ-acquired merchants, and relies on access to Paymark's S2I links on reasonable terms under the wholesale switching agreement.

20. In the following paragraphs, we outline further submissions relating to:

    (a) whether the threat of Verifone and others (such as Payment Express) building their own S2I links would offset the merged entity's market power. We submit that the relevant costs and risks mean that there is no real chance that the threat of building new S2I links would prevent the merged entity from foreclosing rivals;

    (b) the banks' incentive and ability to protect merchants from harm arising from the proposed transaction. We submit that the banks' incentives are not sufficiently aligned with those of merchants to be able to rely on the banks to use their position in the payments system to prevent the merged entity from foreclosing rivals. Furthermore, even if incentives were aligned, the time it would take for banks to identify and respond to a foreclosure strategy would be such that, by the time a response could take effect, irreparable damage to competition may have already been done.

The threat of Verifone building new S2I links would not be sufficient to constrain the merged entity

21. Verifone has previously submitted on the difficulties associated with building new links. As the Commission recognises in the letter of issues, those difficulties include:

    (a) the cost of building each link. Verifone has provided information to the Commission to support Verifone's estimate that each link would cost from $500,000 to $1 million to build;

    (b) the need for co-operation and commitment by the issuer counter-party for each link being built. Those counter-parties may have their own financial interests and competing priorities that reduce their incentive to have Verifone or Payment Express build new S2I links. The volume commitments and financial incentives associated with the proposed transaction might strengthen disincentives to allow the building of new links;

    (c) the risk that failing to build, or delays in building, just one or very few of the necessary links could cause the entire project of building links independent of Paymark's switch to be unsuccessful. This risk may amplify the other difficulties listed above; and

    (d) the number of links that would need to be built. The greater the number of links that would need to be built, the more difficult it would be for the threat of building links to constrain the merged entity, or for any actual build to occur.

22. The Commission has queried whether, to provide an acceptable switching service that is independent of access to Paymark's link, it would be necessary to build links to all 29 issuers or whether links to the top 10 issuers (accounting for 99% of all transactions) would be sufficient.

23. Verifone acknowledges that, for smaller merchants such as dairies and fish and chip shops, the effect of being unable to accept 1% of all transactions may not in itself make a switching proposition unattractive.

24. However, being unable to accept one in every hundred transactions is likely to be a significant issue for larger, higher volume merchants. The custom of those merchants is necessary for a switch to achieve viable scale. Examples of Verifone switching customers that Verifone expects would find the ability to accept only 99% of all S2I transactions unacceptable are **[**

    REDACTED

    ]. We are aware that Countdown has already submitted to the Commission that a payment solution that accepts 88% of transactions would be unacceptable. The Commission may wish to engage with **[REDACTED]** to assess their appetite for a switching solution that leaves them unable to accept one in every hundred transactions.

25. Verifone would not be able to offset the loss of those customers by targeting smaller merchants with a cheaper proposition with reduced S2I coverage. Verifone would need to win an unrealistically high proportion of smaller merchants to make up for those larger merchants' transaction volume, and an even higher proportion of smaller merchants to make up for the revenue Verifone would lose

from processing the larger merchants' transactions. This is because Verifone would need to offer significant discounts to merchants to compensate them for both reduced S2I coverage, and the increases in merchants' costs that are likely to arise from being forced to process more S2A transactions (as discussed in paragraph 8 to 10 above). Those discounts could not be funded through savings in operational costs from having a smaller number of links, as those savings would most likely be less than **[REDACTED]**.

26. Accordingly, Verifone submits that a limited build of S2I links to the top 10 issuers would not be sufficient for Verifone to offer a sufficiently compelling switching proposition that merchants would see as a real alternative to the merged entity's switch. Rather, offering S2I coverage for the top 10 issuers only would accelerate growth in Paymark's and the merged entity's market power. It would be necessary for Verifone to build links to all, or at least the vast majority, of the 29 issuers in order to eliminate its reliance on access to Paymark's switch and effectively constrain the merged entity. **[REDACTED]**.

The banks will have limited incentive and ability to constrain the merged entity

27. In paragraph 50 of the letter of issues, the Commission considers the ability of banks to constrain the merged entity by:

    (a) encouraging the use of S2A transactions (such as contactless payments), or direct to account payment systems, as alternatives to S2I transactions that require access to Paymark's switch; or

    (b) building or threatening to build new links with Verifone and/or Payment Express.

28. The letter of issues goes on to query whether banks' financial incentives would be sufficiently aligned with merchants' interests to prevent adverse competitive effects arising from the proposed transaction, particularly in light of financial incentives in the SPA and services agreements contingent on the proposed transaction for the vendor banks to have transactions processed by Paymark.

29. Verifone submits that the financial incentives that back the vendor banks' volume commitments to the merged entity would be likely to produce a significant divergence between the interests and incentives of the vendor banks, and of merchants. As Verifone has previously submitted, costs to merchants are not the same as costs to the vendor banks. The vendor banks will receive financial rewards for increases in the volume of transactions processed by Paymark, even if some or all of their merchant customers are forced to pay higher switching fees as a result.

30. In addition, even if the banks' and merchants' incentives and interests were aligned, Verifone submits that it would take too long for any response by the banks to anticompetitive conduct by the merged entity to take effect, for that response to prevent foreclosure.

31. First, the banks are only likely to become aware of any anticompetitive conduct after the merged entity has already started engaging in a foreclosure strategy. Merchants would need to see significant cost increases, or find that they are no longer able to or will soon be unable to accept

payments (for example, because the merged entity has manipulated terminal certification and connection processes) before they are likely to exert pressure on banks to respond to anticompetitive conduct in the switching market. At this point, to ensure that they are able to continue conducting business, many merchants may have already been forced to switch to payment solutions offered by the merged entity.

32. Second, the means by which the banks could respond to a foreclosure strategy involve such lengthy processes that, by the time the banks have identified and taken steps to respond to a foreclosure strategy, foreclosure may be complete:

    (a) the Commissions *Mergers and Acquisitions Guidelines* state that, in general, the Commission will consider entry or expansion to be sufficiently timely to constrain a merged entity if it occurs to a sufficient extent within two years.[2] Although Verifone is aware of payment methods having been added to the market, Verifone is unaware of any payment method having been successfully removed from the market altogether. In Verifone's view, direct to account payment methods that bypass the need for a switch are unlikely to become sufficiently popular among both merchants and consumers in the next two years to materially reduce the number of S2I transactions that occur, let alone remove the need for merchants to be able to process S2I transactions. As long as that need exists, and Paymark remains the only switch capable of processing all S2I transactions, the merged entity will have the requisite market power to engage in a foreclosure strategy; and

    (b) building new links is a lengthy and difficult process. It took **[REDACTED]** for Verifone to build the links necessary to complete migration of the Eftpos New Zealand switch away from ANZ.

33. Accordingly, even if banks did have the necessary incentives to attempt to frustrate a foreclosure strategy, it is unlikely that the banks could take action in a sufficiently timely manner to adequately preserve competition in the switching market, or in downstream markets.

Foreclosure: will the merged entity have the means to foreclose rivals?

34. The merged entity's control over the only switching service capable of independently processing S2I transactions will give it the means to foreclose its rivals in downstream markets. Verifone agrees that the means by which it could foreclose its rivals include:

    (a) increasing rival terminal providers' certification fees and/or transaction or connection fees for connection to Paymark's switch;

    (b) making it more difficult for rival terminal providers to obtain certification for their terminals to be able to connect to Paymark's switch;

    (c) degrading the quality of connection between their terminals and Paymark's switch;

    (d) increasing the fees it charges to rival switching providers for access to Paymark's switch, and/or degrading the service it provides to rival switching providers that pay for access to

[2] *Mergers and Acquisitions Guidelines*, page 38, footnote 96.

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Paymark's switch, thereby harming the ability of any rival terminal providers that connect to rival switches to compete with the merged entity.

35. Verifone has already made submissions to the Commission about the ways in which the merged entity could diminish the ability of rival terminal providers that connect directly to Paymark's network to compete with the merged entity. In the paragraphs below, we update and elaborate on the conditions that would allow the merged entity to ensure that affected terminal providers could not avoid a foreclosure strategy by connecting to the Verifone's network (or, for that matter, the Payment Express network).

36. To date, Verifone has not received any revised offers from Paymark for **[REDACTED]**.

37. As the Commission identifies in the letter of issues, Verifone cannot be confident that any pricing terms agreed before the proposed transaction would endure, or that the merged entity would not find some other way to frustrate Verifone's access to the issuer links Verifone needs to provide a viable switching service:

   (a) **[REDACTED]**[3] **[REDACTED]**. The merged entity could **[REDACTED]**. This would drive merchants from Verifone's to the merged entity's terminals, foreclosing competition; and

   (b) the merged entity could use provisions in the **[REDACTED]**[4] **[REDACTED]** to frustrate those agreements. **[REDACTED]**. The relevant provisions in the draft terms would allow Paymark to **[REDACTED]**.

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[3] **[REDACTED]**.

[4] Above n 3.

38. [

REDACTED

], described in Verifone's response to the Commission's information request of 11 July 2018.

Foreclosure: will the merged entity have the incentive to foreclose rivals?

39. It is clear that the merged entity will have the incentive to foreclose its rivals in all of the relevant markets, in order to maximise its profits.

40. Merchants require switching services that are capable of processing S2I transactions. Paymark's S2I links are therefore essential inputs for rival providers of switching services and payment solutions. The merged entity will have the ability to restrict the availability S2I processing services, and foreclose competition for both switching services and payment solutions, without any real risk that rival switches or banks could take any action to thwart a foreclosure strategy.

Foreclosure: will the conduct reduce competition?

41. In Verifone's view, it is clear that an attempt by the merged entity to foreclose its rivals will have the effect of substantially lessening competition. Neither efficiency benefits arising from the proposed transaction, nor the emergence of new payment methods that bypass the need for a switch, would prevent the proposed transaction from substantially lessening competition.

42. Verifone is wary of claims that the proposed transaction may produce efficiencies that offset the competitive harm from a foreclosure strategy. In Verifone's view, any "benefits" from the proposed transaction are likely to be limited to a higher return to the merged entity's shareholders in the form of monopoly rents, with no positive flow-on effects for New Zealand consumers.

43. There is currently a healthy level of competition between Ingenico and rival terminal providers. Verifone is not aware of any evidence to suggest that emerging payment methods will become so popular among bricks and mortar merchants that they could provide the same degree of constraint on the merged entity in downstream markets within the two-year timeframe for assessing the competition effects of a merger. For example, the most significant new payment method introduced in the last decade is contactless payments (which do not bypass the need for a switch). Contactless capability was first deployed in New Zealand in 2011, yet, despite heavy promotion by card schemes and banks and strong demand from consumers, fewer than 30% of all merchants have enabled contactless acceptance on their payment terminals. In addition, those merchants that have enabled contactless acceptance on their payment terminals continue to accept a large number of payments that are not contactless. This highlights the difficulties that would be associated with persuading merchants that they no longer require basic terminal functionality.

44. Even if emerging payment methods do prove popular, the merged entity will be in a position to include emerging payment methods in any foreclosure strategy. Merchants are likely to continue to require access to a switch, either because of their own preferences, or because a small but significant part of the population continues to use payment methods that require access to a switch.

That would allow the merged entity to foreclose competition by, for example, offering discounted bundles of Paymark's switching services, Ingenico's terminals, and its own direct-to-account payment service, so that merchants have little or no incentive to purchase direct-to-account payment services from another provider.

Concluding remarks

45. Verifone shares the concerns the Commission has expressed in its letter of issues. The merged entity will control access to an essential input for rival switching services, terminal providers, and merchants alike, and will not face any real competitive constraints. The merged entity will have the ability and incentive to use that control to foreclose competition across all of the markets in which it participates, by forcibly limiting its rivals' offerings to solutions that are unacceptable to merchants.

46. Please contact us if you have any questions about this submission.

Confidentiality

47. Confidentiality is sought for the information in this submission that is in square brackets and highlighted. We are also providing a public version of this submission, with the confidential information redacted.

48. Verifone requests that it be notified of any request made under the Official Information Act for the confidential information, and be given the opportunity to be consulted as to whether the information remains commercially sensitive at the time that the request is made.

49. These requests for confidentiality are made because the information is commercially sensitive and disclosure would be likely to unreasonably prejudice Verifone's commercial position.

Yours sincerely

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