

Anticipated joint venture between LINK Interchange Network Limited and Transaction Network Services (UK) Limited

The OFT's decision on reference under section 33 given on 27 January 2005

Please note square brackets indicate figures replaced by a range at the parties' request.

PARTIES

1. **Link Interchange Network Limited (LINK)** is a private limited company wholly owned by 22 financial institutions. It provides electronic transaction management services to financial institutions and other commercial organisations in the UK. LINK also runs the LINK automated teller machine (ATM) network. Its outsourcing division, ATMOS, provides outsourced transaction management services in Europe, including the overlap areas considered below. In the year to 30 June 2004, LINK's UK turnover was £35m.
2. **Transaction Network Services (UK) Limited (TNS)** is a private limited company and is a wholly-owned subsidiary of Transaction Network Services Inc. TNS operates in the UK primarily as a data communications services provider for transaction-oriented applications. For the year ending 31 December 2003, TNS's UK turnover was £20.8m.

TRANSACTION

3. LINK and TNS propose to enter into a joint venture (JV) to provide electronic financial transaction (EFT) services, namely ATM deployer services,¹ card issuer services, and card schemes gateway access services. The JV will be 75 per cent owned by LINK and 25 per cent owned by TNS. It will be a member of the LINK group of companies.

¹ An ATM is commonly known as a cash machine and the industry refers to its owner as an 'acquirer' or 'deployer'; the latter term is used in this decision for convenience.

4. The parties notified the transaction on 10 November 2004 and the 40-working day administrative deadline expired on 10 January 2005.

JURISDICTION

5. As a result of this transaction, LINK and TNS will cease to be distinct and the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met since their combined share of the supply of outsourced ATM transaction processing services in the UK will be [80-90 per cent] by number of ATM machines (and [35-40 per cent] by volume of transactions) processed. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation for the purposes of section 33(1) of the Act.

RELEVANT MARKET

Background

The LINK ATM network

6. Prior to the mid 1980s, ATMs were characterised by 'on-us' transactions where a cardholder was only able to carry out cash withdrawals and other related transactions at ATMs deployed by its card issuer.² In 1985, the LINK network was established to facilitate ATM sharing between the customers of several small banks and building societies (BBS), so called 'shared' or 'us on them' transactions, where ATMs owned by different BBS can share cash acquisition transactions via the LINK network's central switching hub.³ In practice, this means that cardholders are able to withdraw cash and carry out certain other related transactions from any LINK branded machine if their card issuer is a LINK member.
7. In 1999, the LINK network extended its membership further to independent ATM deployers (IADs). Today, the LINK network has 51 members⁴ which comprise both large and small BBS, card companies and IADs. 75 per cent of all cash acquired in the UK is withdrawn from ATMs and over 60 per cent of withdrawals

² These are commonly referred to as 'free' ATMs and are typically located at banks, supermarkets and railway stations. They carry a sizeable cash float and generate a large volume of transactions.

³ 'On-us' transactions do not pass through the LINK hub as the card issuer and ATM deployer is the same.

⁴ Source: LINK web site: www.link.co.uk

from ATMs are shared transactions⁵, i.e. they pass through the LINK central switch.

IADs

8. The number of ATMs deployed in the UK has been rising rapidly, from around 19,000 in 1993 to over 46,000 in 2003. Although some of this growth is attributable to BBS, the large majority is due to IADs. From none in 1999, the number of IAD operated ATMs has risen sharply from around 4,000 in 2000 to 14,500 in 2003.⁶ These are either new ATMs or ATM estates acquired from small BBS that consider this to be a 'non-core' activity and choose to focus on their other 'core' businesses. The growth in the number of IAD ATMs, in particular, is expected to continue. The majority of IADs earn revenues by charging the cardholder a fee, typically around £1.50 per transaction, for using their ATM.⁷ IADs generally locate their ATMs, with the exception of their acquired BBS estates, in convenience locations for example a public house or convenience store, whereas large BBS tend to locate their ATMs in high streets (including inside the branch) and in locations characterised by a high volume of transaction flows.

Areas of overlap

9. The parties are both active in the supply of ATM deployer services, card issuer services, and card schemes gateway access services. In relation to both card issuer services and card schemes gateway access services, there are numerous suppliers and no third party raised any concerns. Therefore these are not considered further.
10. The precise nature of ATM deployer services is often agreed in bespoke contracts, and use of terms among market participants does not appear to be uniform. The following analysis relies principally on the parties' definitions. The parties characterise the transaction as creating overlaps in the following four (of a proposed breakdown of ten total) ATM deployer services:
 - **Transaction processing.** This controls the operations of the ATM. The processing software connects the ATM to the LINK switching hub, routes the

⁵ Source: LINK web site: www.link.co.uk

⁶ Source: The APACS Yearbook of Payment Statistics. IADs' ATMs are typically referred to as 'convenience' ATMs. They are stand-alone machines generally located in pubs and convenience stores. They operate with a smaller cash float and generate fewer transactions than 'free' ATMs.

⁷ An ATM deployer has a choice of either entering into the interchange fee arrangement as part of the LINK network (fee being paid by the card issuer to the ATM deployer) or charging a fee to the cardholder. The ATM deployer cannot obtain revenue from both.

transactions to the correct destination, manages information, enables cash withdrawals, and displays on screen information to the ATM user.

- **Reconciliation and post-settlement.** Reconciliation records and reconciles the transaction that is processed via the ATM with data supplied by the LINK network, and post settlement entails the transfer of funds to the ATM site owner.
 - **Supplier management** involves managing a supplier relationship.
 - **First-line maintenance** is a remote helpdesk service which supports remote ATM sites when hardware problems arise.
11. A substantial number of third parties raised concerns about the merger in relation to transaction processing, but no concerns were raised in relation to the other areas of overlap between the parties. Accordingly, the focus of the OFT's inquiry has been on transaction processing, as reflected by the remainder of this decision.

Product market

12. Transaction processing is critical to the function of an ATM and is designed to meet a specific customer requirement. Customers indicate that there are no close demand-side substitutes to this particular service.
13. In terms of the identity of the transaction processing providers, the parties submit that the distinction between outsourced and in-house transaction processing services is of no material relevance as outsourcing customers can switch to self supply. The degree to which this acts as a potential constraint on the JV is considered further at paragraphs 20 to 23 below.
14. On the supply side, depending on the contract requirements of the customer, transaction processing services can be supplied on their own or in a package together with other ATM deployer services. In the latter case, the transaction services provider can either perform all of the ATM deployer services itself or it can sub-contract out some of those services to other service providers. Our investigation considered whether providers of other EFT services could and would in the short term become a third party supplier in the event of a 5-10 per cent price increase in transaction processing services. The OFT is not aware of any instances of switching in the past and there is insufficient evidence to show supply-side substitutability between any other EFT services and transaction processing, in part, because of the cost and time required to do so and the volume of business needed to make switching profitable. (Entry into transaction processing services is considered in more detail below.)

15. Overall, the evidence suggests that it is appropriate to focus our inquiry into the potential anti-competitive effects of the JV on the overlap in the supply of outsourced transaction processing services.

Geographic market

16. With the exception of one provider, suppliers of ATM transaction processing services in the UK, including the parties, are all based in the UK. On this basis, a cautious view is taken that the appropriate geographic frame of reference is the UK.

HORIZONTAL ISSUES

Non-coordinated effects

17. As summarised below, the weight of evidence available leads the OFT to conclude that horizontal competition concerns would arise in transaction processing since the JV would combine the two principal UK outsourced transaction processing providers, and each other's closest competitor:
- **The JV would be the incumbent supplier for over 80 per cent of current customers.** Of the 19 ATM deployers that, to the OFT's knowledge, currently outsource transaction processing, the parties supply 16 customers (ATMOS – 9; TNS – 7), with IBM and Euronet accounting for two and one customer(s) respectively.
 - **The only example of pre-merger switching is between the parties.** Switching evidence available to the OFT is limited, as contracts are typically of several years' duration and many IADs and other customers have not yet gone through multiple contractual cycles. Nevertheless, the only evidence of actual switching in the last five years is of one customer switching its transaction processing provider from LINK to TNS in 2003.
 - **Combined shares are high on any available measure of supply.** The parties indicate that their post merger share of the supply of outsourced transaction processing in the UK by the number⁸ of ATMs would be [80-90 per cent] (increment [5-15 per cent]) with IBM and Euronet accounting for [5-15 per cent] and [0-10 per cent] respectively. By volume of outsourced transactions processed, the parties combined share of supply post merger would be [35-45 per cent] (increment [0-10 per cent]) with IBM accounting for [45-55 per cent]

⁸ The parties did not provide share data by value.

and Euronet [5-15 per cent]. However, in terms of volume data, Euronet's share accrues from a single contract, as does nearly all of IBM's share.

- **Customer concern is high.** The OFT received a significant number of concerns from customers as well as other third parties. These may generally be summarised to the effect that the merger would combine the two major choices for outsourcing transaction processing in the UK.
18. Although the above factors raise serious competition concerns, the OFT has considered carefully whether sufficient evidence supports countervailing arguments that dispel these concerns. The parties argued that the JV will be effectively constrained post merger by: (i) the two other outsourced ATM transaction processing providers, IBM and Euronet; (ii) the threat of ATM deployers currently outsourcing transaction processing switching to conduct processing in-house; and (iii) the threat of new entry.

Existing competitors

19. The OFT's investigation indicates that IBM and Euronet cannot be expected to constrain the parties' post merger behaviour sufficiently to remove the above concerns. The degree to which each would be a credible competitive alternative to the JV is called into question by third party evidence. It appears that the success of IBM and Euronet in winning their two and one contracts respectively relates to the individual facts of the contract or customer, namely, broader or historical commercial relationships. As noted above, many customers expressed concerns about the transaction, and do not appear to regard either IBM or Euronet as actively pursuing business or in any event as an effective alternative to the JV.

Self-supply by customers

20. Transaction processing among large banks has historically been performed in-house, and self-supply remains the norm (although the parties intend to attract business that is currently provided in-house through the JV). In contrast, almost every IAD has outsourced transaction processing since entering the ATM sector. A significant number of small BBS also rely on outsourcing. Small BBS and IADs vary in the number of ATMs they deploy but are generally characterised by a small number of ATMs and low volumes of transaction flows relative to the self-supplying large banks.
21. The parties contend that the threat of moving to in-house provision by small ATM deployers will act as a competitive constraint on the JV, arguing that the cost of in-house provision by small ATM deployers is low because transaction processing

is a simple service which requires 'off the shelf' software and hardware and costs are in proportion to the scale of the business.

22. This position was not corroborated by the weight of third party evidence received. No small ATM deployer respondent to the OFT's inquiry currently reliant on outsourcing identified in-house provision as a credible option for it to constrain external providers. There is no evidence of an IAD switching from outsourcing to in-house provision. The OFT sought to test whether, on an objective basis, the costs of in-house provision are such that it would be a feasible alternative, assuming no customer inertia, in response to a small but significant price increase in transaction processing charges by external providers. However, cost estimates from various sources differed substantially, and no firm conclusions can be drawn.⁹
23. While the OFT has identified isolated examples of in-house provision outside the larger financial institutions, in most cases there appear to be historical or other customer-specific reasons for this that would not appear to be transferable to other outsourcing clients of the parties. This suggests that customer switching to in-house provision is unlikely to occur, or not in sufficient numbers so as to render an increase in prices from current levels unprofitable. Even assuming limited switching, as each contract price is individually negotiated, there remains a realistic prospect of price discrimination whereby the JV could impose higher prices (than absent the transaction) on those customers unable or unwilling to switch to internal supply.

Barriers to entry and expansion

24. While further investigation may reveal that the JV would face effective competition from one or more new entrants, the weight of evidence available during the OFT's inquiry does not support such a conclusion.
25. Various barriers to entry were identified by market participants. Perhaps the most significant are scale economies enjoyed by LINK and TNS, which may well be heightened as a result of the merger (which is not to deny that scale economies can be a source of efficiency). For an entrant to become cost-competitive with the JV, it would need to win a substantial volume of business in the short term. However, large-volume outsourcing contracts are rare (the large banks all self-supply, and the only such contract is the Co-op's) and new business opportunities arise only infrequently (e.g. every 3-5 years). One third party told the OFT that it

⁹ An initial conclusion, based on best available estimates, suggests that ATM deployers whose transaction volumes are below 10 million per annum are unlikely to find it cost-effective to supply internally even if outsourcing prices rose by 5-10 per cent.

had examined the costs using an alternative transaction processing provider, but found the rates uneconomic. There is no example of new entry within the last five years.

26. Market participants also identified reputational barriers to entry, as lack of experience in what amounts to a critical function for an ATM deployer may discourage customers from contracting with a new market entrant. Switching costs are also present because engineers are required to reconfigure any software at an estimated cost typically around £200 per ATM. Finally, a cost of entry to which several third parties attach significance was the payment of membership and or connection fees to LINK, which must also be paid for each ATM deployer with whom the transaction processing provider has a contract.¹⁰
27. Notwithstanding the above, the OFT did consider in more detail various candidate entrants put forward by the parties. There is some basis for suggesting that eFunds in particular is a plausible entrant given that: (i) it is a major provider of ATM transaction processing services in the United States, suggesting that it has the IT and other resources to enter, and would not face reputational barriers in doing so; and (ii) it has applied for 'Certified Service Bureau' (CSB) status with LINK, enabling it to provide services to more than one LINK member, arguably demonstrating a commitment to enter the UK transaction processing sector. At the same time, however, no customer responding to the OFT identified eFunds as a credible potential entrant, and the OFT has no evidence that eFunds has been invited to bid for any contracts in the UK. It is also questionable whether eFunds could secure the volume of transactions necessary to make entry into the UK cost-effective. Although eFunds may benefit from economies of scale by routing processing via its U.S. data centre, whether a transatlantic solution would persuade customers is uncertain.
28. Other candidate entrants put forward include Wincor Nixdorf and First Data, but the available evidence is too speculative and/or unsupported by third parties to provide the basis for any robust conclusions.
29. In summary, given the reduction in rivalry between the parties that may result from the JV, the mixed evidence available to the OFT does not demonstrate that entry by one or more such players would be timely, likely or sufficient in scope to deter the JV from raising prices or reducing output and/or quality post merger.¹¹

¹⁰ Third parties cited these additional costs as a reason why small ATM deployer customers, especially those with low transaction volumes, are more difficult to target by new entrants because it would not be cost-effective.

¹¹ OFT Mergers substantive assessment guidance – para 4.17 to 4.26

Buyer power

30. Small ATM deployers do not enjoy significant buyer power because they do not represent large proportions of demand and cannot credibly threaten to self-supply in processing. Any buyer power on the part of large BBS will not protect small ATM deployers, as pricing is set in individual contract negotiations.

Conclusion

31. The loss of rivalry between LINK and TNS brought about by the merger raises a realistic prospect that competition in the supply of outsourced transaction processing services to ATM deployers in the UK will be substantially lessened. The evidence on countervailing constraints is insufficient to dispel this concern. Customer detriment may take the form of higher prices or lower service quality than absent the merger, and/or a loss of innovation in relation to the parties' hitherto competing software solutions.

VERTICAL ISSUES

32. There is no evidence that this transaction raises any vertical competition concerns.

THIRD PARTY VIEWS

33. Of the customers outsourcing their transaction processing requirements that responded to the OFT's inquiry, all expressed significant competition concerns that the JV would combine their two main choices of supplier, and feared price increases and a general reduction in service quality. The large BBS respondents, all of whom self-supply, had no concerns.

ASSESSMENT

34. The parties are proposing to enter into a JV to provide various EFT services. Of the various areas of overlap, only outsourced ATM transaction processing raises competition concerns. Here, the JV would account for over 80 per cent (16 of 19) of outsourced transaction processing contracts in the UK, and combine the two principal suppliers to customers that outsource this critical requirement. Customer concerns were both significant and widespread.
35. While market shares on a transaction volume basis (but not by number of ATMs processed) appear to present IBM and Euronet as credible competitors, other evidence, notably from customers and other third parties, makes it questionable whether either or both would be sufficient to constrain the JV post merger. Equally, the evidence does not demonstrate the argument that in-house provision

by currently outsourcing customers would be an effective constraint, as this is neither a core business nor a cost-effective solution for such customers relative to external supply.

36. Finally, barriers to entry are significant, although certain candidate suppliers, notably eFunds, appear to be plausible entrants. However, the OFT cannot rely on the mixed record of evidence to conclude that entry would be timely, likely and sufficient to alleviate the competition concerns raised by the JV.
37. Consequently, the OFT believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom

UNDERTAKINGS IN LIEU

38. LINK has indicated that it is willing to offer two undertakings in lieu of reference pursuant to section 73 of the Act.
39. First, LINK has offered to apply a price cap on the JV's processing fees with the cap to be based on existing prices to customers with equivalent predicted annual transaction volumes. LINK has specified that an indexation uplift ought to be permitted to the price cap and the terms and conditions, service and support levels and standards of performance be equivalent to those currently offered.
40. Second, in addition or in the alternative, LINK has offered to provide 'toll processing' to third party service providers on fair and reasonable terms but subject to available capacity, and where objectively required by the third party to compete with the JV. In addition, LINK said that it will not, in the absence of objective justification, discriminate between the JV and the third party whether in relation to prices charged or to other terms and conditions.
41. In relation to the first undertaking, besides the burden of price regulation, it is not clear that the price cap would replicate the ongoing competitive pressures on price and service levels generated by pre-merger rivalry between the two main suppliers. (Indeed, evidence available to the OFT suggests that pre-merger the price of processing services is falling, which also calls into question the remedial nature of a price cap.)
42. There are also real doubts as to the effectiveness of the second undertaking. First, it is unclear how admission of the market to a third party entrant, contractually dependent on the JV for supply, would restore effective competition and second, the undertaking presents considerable enforcement difficulties and burdens.

43. Neither remedy proposed by LINK amounts to a clear-cut remedy capable of ready implementation. Accordingly, neither can be accepted as an undertaking in lieu of reference. The OFT is not, therefore, relieved of its duty to refer the merger to the Competition Commission given its belief that it is or may be the case that the merger may be expected to result in a substantial lessening of competition in the UK.

DECISION

44. This merger will therefore **be referred** to the Competition Commission under section 33(1) of the Act.