THE PSR'S INFRASTRUCTURE REPORT

THE ROLE OF COMPETITIVE TENDERING

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1. INTRODUCTION AND SUMMARY

The Payment Systems Regulator (PSR) has now published its final report on infrastructure provision[i] – focusing on the bundle of hardware, software and services VocaLink supplies, the key payment schemes, Bacs, Faster Payments, and LINK, the operators of the UK's ATM network.

Its verdict is stark – 'there is currently no effective competition in the market for the provision of central infrastructure services [by VocaLink]'[ii] – although the report acknowledges that 'most operators and direct PSPs are satisfied with the value for money, quality of service and innovation they receive'[iii].

The report suggests 'a package of remedies'[iv] – a competitive tendering exercise for core services, standardisation on internationally accepted messaging standards, and divestment by the four largest banks of their interests in VocaLink.

However, there are aspects of this package which have been overtaken by two key developments which occurred in July as the PSR was finalising the report:

- The sale of VocaLink to MasterCard, subject to regulatory clearances, announced on 21st July.
- The publication of the Payment Strategy Forum's draft strategy[v] on 13th July, including a recommendation[vi] to create 'a new architecture for retail interbank payments, the 'Simplified Payments Platform' (SPP)'.

In this note, we[vii] focus on how these two developments have affected the PSR's package of measures, and specifically its call for a competitive tendering exercise for *existing* systems. We agree with the PSR that competitive tendering exercises for asset-intensive utilities can produce significant savings (of the order of 20% or more). However, as we have seen with the saga of rail franchising, there can be difficulties in implementing a competitive tendering approach. It is also worth noting that cost savings do not always automatically flow through to final customers; for instance, savings made in upstream parts of the supply chain, will only flow through to final customers if retail markets are competitive. The fact that most in-credit personal customers enjoy free payment services is an added consideration in this context.

In addition, from a cost perspective, the services supplied by VocaLink are not as asset-intensive as those in energy or transport utilities – instead they are more typical of those provided by data communications companies[viii]. The costs for the central 'switching' service provided by VocaLink are only a small proportion (10% or less) of the total end-to-end cost of making a payment. The other 90% of the costs fall on the originating and receiving Payments Service Provider (typically a bank).

This leads us to ask about the conditions under which competitive tendering can offer significant benefits to end users, and whether a competitive tendering exercise for the Bacs and Faster Payments (FP)[ix] infrastructure would meet these conditions. These benefits could be either cost savings on the bundle of hardware and software services VocaLink currently supplies, or a more innovative approach to the services Bacs and FP can offer their customers. The PSR report emphasises both of these points[x].

As we discuss in the following sections, this analysis leaves us with concerns that a competitive tendering process may be more difficult, and produce fewer net benefits, than the PSR envisages.

In addition, we think that the PSR (and the Payments Community as a whole) would get more 'bang per buck' (or perhaps more accurately, 'bang per hour of effort expended') in ensuring that the new SPP furthers its competitiveness objective, rather than focusing on infrastructure competition for the legacy Bacs and FP systems. This would be in line with the PSR's objective, under FSBRA, 'to use the resources of the Payment Systems Regulator in the most efficient and economic way'[xi].

Our note is intended as a contribution to the ongoing debate about payment infrastructure provision. We note that the PSR states that it has not currently 'carried out a detailed assessment of these high level remedy options for either their effectiveness or proportionality'[xii] – and as the report makes clear elsewhere, proportionality includes cost-benefit considerations[xiii]. Our comments cover both matters and we hope they will prove useful for the next stages of the PSR's deliberations.

2. When is competitive tendering most likely to yield benefits?

It is easiest to start with where we agree – that competitive tendering can produce significant gains for consumers. For example, CEPA has produced two reports[xiv] for Ofgem on the benefits of the competitive tendering regime for offshore electricity network operators. By constructing a counterfactual of what the costs would have been *without* competitive tendering, CEPA was able to demonstrate a range of cost savings varying from 14-27% for the first tender round to 32-45% for the third tender round[1].

Some of CEPA's observations are particularly pertinent to the current payments infrastructure debate. For example, CEPA notes that competitive tendering:

- has removed the asymmetries of information that have traditionally put regulators at a disadvantage to operators regarding efficient operating costs; and
- has allowed *actual* financing costs, rather than those based on a notional rate of return calculation, to be used.

The CEPA work also points to other factors that drive the benefits of competitive tendering, notably 'the structuring of [bidding] opportunities that made bidders willing to bid efficiently'. These included the significant de-risking provided by the operational nature of the assets and the length of the licence awarded – twenty years.

[1] Note, however, that these savings did not necessarily accrue to final customers.

Not all examples of competitive tendering yield successful results, however: the UK rail franchise system has experienced a number of problems, with around half of the original passenger franchises awarded since 1997 have had to be renegotiated ex-post, and with two major reviews[xv] of the system within five years. One of the problems rail has highlighted is that supposedly 'irrational' bidding tactics (for example, overoptimistic demand forecasts, ignoring downside risks) may in fact be sensible for a bidder if they can renegotiate the franchise terms or, in extremis, walk away from the franchise altogether.

While the CEPA studies looked at competitive tendering for regulated utility assets, the situation is of course similar for procurement in the private sector. Competitive tendering elicits market information, realises commercial benefits and confirms the efficiency of prices, which a single source negotiation would struggle to do because of information asymmetry between buyer and seller – for example between original equipment manufacturers (OEMs) and their suppliers of specialist parts.

But for competitive tendering to yield significant benefits, the purchaser has to base their decision on total cost of ownership - not just the quoted price but *all* of the costs incurred in selecting a competitive tendering approach, including own internal resource costs, risks and opportunity costs. Otherwise the purchaser risks winning a Pyrrhic victory of a low contract price but with high internal resource costs or high probability of future cost creep, or both.

Furthermore, the tender mechanism needs to be carefully designed to incentivise bidders to participate and to submit their best bids. At the very least bidders need to see that they have a fair chance of winning the business. Otherwise they have little reason to invest the effort for putting in *serious* bids.[xvi]

To summarise we might say that, in the right circumstances and with suitable mechanism design, competitive tendering can yield significant benefits, but that the design of appropriate competitive tendering processes is difficult, and takes time and resource to implement effectively.

3. WOULD THESE BENEFITS REALISE FOR THE UK PAYMENTS SYSTEMS?

Against this background, we need to examine whether the proposals to implement a full competitive tendering process for Bacs and FP infrastructure would be likely to deliver *significant benefits to consumers.*

Aside from the question of the relevance of cost savings pass-through in this context, our view is that the PSR has underestimated some of the difficulties that a competitive tender for an *existing* payments system would cause. For example, the Lipis Report[xvii], commissioned by the PSR as an input into the infrastructure review, shows that:

- competitive tenders for payment systems are rare (see, for example, Lipis Report, p 28); and

- only Japan has ever retendered a legacy (i.e existing system) and there the incumbent (NTT Data) has won every time (Lipis Report, p 92).

This leads the Lipis Report to conclude, not surprisingly, that the UK arrangements are fairly typical, and to point out, in its conclusions, that 'in existing systems, incumbent infrastructure providers have a huge advantage over other potential providers'.[xviii] As we have discussed above, this significant incumbent advantage would limit the likelihood of competitors to VocaLink putting in the effort to make a serious bid.

Why is this? One of the key reasons can be found in the response Faster Payments made to the PSR's Interim Report on Infrastructure. After referring to the Lipis Report, FP notes[xix]:

'*Migrating a large scale batch ACH let alone a real time 24 x 7 payment system from one infrastructure to another, seamlessly, has never been done. It is almost certain that an extensive period of parallel running would be required before the operational and financial stability and integrity of a new system could be confirmed. This parallel running in itself adds significant industry-wide cost, especially in participants, and also introduces new operational risks.*'

FP, in this submission, emphasised that the costs of a competitive procurement exercise included not only the bidding costs of designing and running a competitive tendering exercise, but also the 'parallel running' costs of having two payments infrastructures live for a period to ensure stability. These costs would fall both on FP and potentially on the Payment Service Providers (PSPs) using the service.

A second key reason lies in the non-standard messaging system used by Bacs in particular, and here the recommendations made by the PSR are sensible and likely to enhance competition by lessening the incumbent advantage.

Similarly, while neither Bacs nor FP make the point, their last contractual negotiations with VocaLink covered a relatively short contract period – three years in the case of FP – as the Payments Council had required their contracts to be coterminous at some point between 2018 and 2020. No competitor to VocaLink was likely to be interested in challenging an incumbent for a contract which lasted for such a short length of time given the amount of investment that would likely be required.

Payment infrastructure shares three characteristics with IT systems and certain customised engineering products, which could explain the hesitation of Bacs and FP to go to competitive tender.

Firstly, switching suppliers of such systems requires significant investment not only by the new supplier, but also by the purchaser (at least in terms of project management resources and cost of risk). Secondly, the initial investment by the incumbent is sunk and it is therefore irrelevant *now* whether or not another supplier could have built the system more efficiently at its inception, or been more innovative in the services which were offered. Thirdly, the operating costs of such systems should be very similar between different suppliers, which makes it difficult for a new supplier to recover investment costs from an offer that undercuts the incumbent on operation cost, *unless* they can introduce major process innovations (for example, offshoring functions like help desks or system testing).

These three characteristics are found in many situations, from IT systems to supply of engineering parts to OEMs. They give the incumbent a strong advantage in competition with potential challengers. In such situations the rational business decision for the purchaser might be to accept the lock-in and not to go to competitive tender, unless there are other business considerations, such as grievances with the incumbent or strategic re-balancing of the supplier portfolio, or strong reasons to believe that a new supplier could quote on basis of fundamentally different cost structures, for example due to technological innovation or geographic location, and thus beat the incumbent by a margin which allows a rapid recovery of investment costs.

If the lock-in is strong, competitive tendering could even lose its power to reveal market information: Where challengers suspect that they are only used to extract concessions from the incumbent with no chance of actually winning the business, they are unlikely to submit bids that are as strong as they could otherwise be.

The incumbent's advantage is smallest (and the keenness of challengers therefore greatest) where systems have to be upgraded or redesigned in some form anyway. At these natural switching points the investment requirements for incumbent and challengers are similar enough so that challengers have a real chance to overcoming the costs of switching. It is these switching points where the maximum power of competitive tendering should be applied to realise its full benefits – in particular if long lock-ins are to be expected after the award.

For Bacs and FP, the earliest natural point for a competitive tender would be when the present contracts fall due for renewal (between 2018 and 2020). At that point, a longer contract period could be offered, and – if the PSR's recommendations on interoperability and messaging have been implemented – Bacs and FP may find themselves able to run a competitive tendering exercise. for less bespoke solution. While such a competitive tendering exercise would still require significant investment and resources to support switching, the more standardised nature of the requirements could allow competing infrastructure providers to offer major process innovations and hence cost savings.

However, we then come to the second development, referred to in the introduction – the Forum's recommendation[xx] for a new SPP. Given the level of banking industry involvement in the Forum, and the development of the SPP concept from Payments UK's work on a World Class Payments System, there must be a high likelihood of such a platform coming to fruition – although not at any time soon. The Forum sensibly recommends 'further detailed work', to be completed by 2018.

There are several implications of the proposed new SPP. Firstly, as we have seen from the Lipis Report, it is much easier to design competition in to a new payments system than to retrofit it to existing legacy systems – and here the proposals for a layered architecture and the use of Open Access APIs should make the new SPP much less subject to a dominant infrastructure provider than the current arrangements.

Secondly, the likelihood of running a successful competitive tendering exercise would be reduced. It is unlikely that Bacs and FP would wish to make major upgrades or redesigns to their services, as the payments community will have decided to achieve service user improvements via the SPP. And volumes on the existing FP and Bacs systems would be in decline as payment transactions migrate to the new SPP. So the natural 'switching point' referred to above which lessens incumbent advantage will be unlikely to occur, and it would be more difficult (perhaps impossible) to attract infrastructure providers willing to challenge the incumbent (VocaLink).

Thirdly, even if a CT exercise were to be run successfully, the benefits would be less than they would be in a world without the SPP, as payments are likely to migrate away from Bacs/FP to the new SPP system – so even if there were a significant cost saving per transaction, savings overall would be lower because there would be fewer Bacs/FP transactions.

So overall we are sceptical whether the undoubted benefits of competitive tendering could be realised *for the existing payment systems* as the PSR hopes, particularly given the potential development of the SPP. We now comment on what that means for the PSR's package of measures.

4. WHAT SHOULD THE PSR DO NOW?

The two developments we referred to in the introduction have a major impact on the package of remedies that the PSR has proposed.

The sale of VocaLink to MasterCard, provided it secures the necessary regulatory approvals, effectively implements the PSR's recommendations on the four major banks' joint control of both Bacs/FP and VocaLink, which the press statement for the final report acknowledges. It also has implications for the proposed remedies on competitive tendering, where the report sets out four options, indicating a preference for mandating the boards of Bacs and FP to undertake a competitive procurement exercise.

We find difficulties with this approach. If the major banks are not exercising joint control of the boards of Bacs/FP and VocaLink, why cannot the former be left to decide for themselves what form of tendering process is best? As we have seen, while competitive tendering can produce significant benefits, there are major concerns about whether it would do so here. If the boards cannot be trusted to take this decisions, what can they be trusted with?

In this context we need to recall that, in addition to the bank-appointed directors, both Bacs and FP have independent chairs and independent directors who can exercise a veto on any decision not in the public interest – including any proposal on procurement that they consider would fail this public interest test.

So we think that the issue of competitive tendering on legacy systems should be left to the boards – armed now with a report from the PSR which should enhance their bargaining power in securing more concessions from VocaLink's new owners.

Instead, we think the PSR should focus its limited resources on the wider issue of competition between payment schemes which can drive innovation and reduce costs to consumers. We already see this in the competition *between* bank-based operators like Bacs and FP *and* the card schemes, and in the role that 'overlay' providers such as PayPal have played in offering innovative services. From the perspective of customers who enjoy free payment services, the benefits from competition are inherently about quality of service rather than cost.

The development of the SPP will provide further opportunities for competition and innovation – provided it is allowed to compete effectively both with existing bank-based operators and with card schemes. This will depend on what kind of business model SPP is based upon – does it follow the mutual, banking-led model of the existing interbank operators, or the for-profit commercial model into which MasterCard and Visa and other card operators (American Express, JCB, Diners Club) have now evolved? Both the impressive record of the card operators on innovation (contactless, tokenisation) and the history of other central service providers, like the London Stock Exchange, which demutualised and then competed with other platform providers on the global stage, suggest that the for profit route is the way to go.

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i. See http://bit.ly/2bsRUxu
ii. Para 1.9
iii. Para 1.11
iv. Para 8.3
v. See http://bit.ly/2bJiD7O
vi. Para 8.1
vii Richard Gleed is a Senior Adviser at CEPA; Mark Cockburn is a Director at CEPA; Daniel Wagner is a Managing Consultant at TWS Partners, who advise clients on commercial negotiations.
viii Such as the Data Communications Company that manages the smart metering programme for Ofgem (see www.smartdcc.co.uk)
ix. In this note, we concentrate on these two systems; the wholesale system, CHAPS, is operated by the Bank of England as an integrated system, and the new Image Clearing System for C&CCC has just gone through a competitive tendering process. The PSR Report also covers LINK, but the arguments there are somewhat different.
[x] See for example para 1.11: 'there is scope for effective competition to drive improved outcomes in terms of value for money, service quality and innovation.'
xi. See Section 53 of Financial Services (Banking Reform) Act 2013 – the authors are indebted to Suzanne Rab for drawing our attention to this.
xii. Para 8.4
xiii. Para 8.15
xiv. Reference required
xv. The McNulty report published in 2011, and the Brown Review of the Rail Franchising Program; in addition there was the Laidlaw Report on one specific tender.

[xvi] Beyond encouraging mere participation, the design of the negotiation mechanism plays a crucial role for how far bidders will push their bids towards efficient prices. Best practice in commercial procurement draws on economic game theory to design negotiation mechanisms that maximise the incentives of bidders for submitting their strongest bids.

xvii. See http://bit.ly/2bPc1XC

xviii. Page 64

xix. See the responses to the Interim Report at http://bit.ly/2bgcr6v

xx. See Chapter 8 of the Forum's Draft Strategy