

This Transcript has not been proof read or corrected. It is a working tool for the Tribunal for use in preparing its judgment. It will be placed on the Tribunal Website for readers to see how matters were conducted at the public hearing of these proceedings and is not to be relied on or cited in the context of any other proceedings. The Tribunal's judgment in this matter will be the final and definitive record.

IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1146/3/3/09

Victoria House,
Bloomsbury Place,
London WC1A 2EB

26th October 2010

Before:

MARCUS SMITH QC
(Chairman)

PROFESSOR PETER GRINYER
RICHARD PROSSER OBE

Sitting as a Tribunal in England and Wales

BETWEEN:

BRITISH TELECOMMUNICATIONS plc

Appellant

– and –

OFFICE OF COMMUNICATION

Respondent

– and –

(1) CABLE AND WIRELESS UK
(2) VIRGIN MEDIA LIMITED
(3) GLOBAL CROSSING (UK) TELECOMMUNICATIONS LIMITED
(4) VERIZON UK LIMITED
(5) COLT TECHNOLOGY SERVICES

Interveners

*Transcribed from tape by Beverley F. Nunnery & Co.
Official Shorthand Writers and Tape Transcribers
Quality House, Quality Court, Chancery Lane, London WC2A 1HP
Tel: 020 7831 5627 Fax: 020 7831 7737
(info@beverleynunnery.com)*

HEARING
(Partial Private Circuits)
DAY FIVE

APPEARANCES

Mr. Graham Read QC, Mr. John O’Flaherty and Mr. Ben Lynch (instructed by BT Legal) appeared for the Appellant.

Mr. Pushpinder Saini QC, Mr. James Segan and Mr. Hanif Mussa (instructed by the Office of Communications) appeared for the Respondent.

Miss Dinah Rose QC and Mr. Tristan Jones (instructed by Olswang) appeared for the Interveners, Cable & Wireless UK, Virgin Media Limited, Global Crossing (UK) Telecommunications Ltd, Verizon UK Limited and COLT Technology Services (the “Altnets”).

1 THE CHAIRMAN: Miss Rose, before you being, I thought I would raise one matter for the
2 parties to think over. It looks like we will finish the evidence today, and we were thinking –
3 but do not respond now – that you might like to have Wednesday to prepare your
4 submissions and then Thursday and Friday to make them.

5 MISS ROSE: We had had a similar discussion between counsel, and certainly I would agree that
6 that would be a sensible way forward. We think we should be able to complete all the
7 closing submissions within two days.

8 MR. READ: Can I put a plea in, sir, because on the present timetable for the closing we have
9 10.30 starts, if the Tribunal can sit at 10 on Thursday and Friday, that would help ensure
10 that we do not have to trickle over on to Monday if we can avoid it.

11 THE CHAIRMAN: That would be desirable to avoid and we are certainly able to sit at 10 if
12 everyone else is. In that case that is the plan unless anyone has later suggestions.

13 Professor GEORGE YARROW, Recalled

14 Cross-examination by Miss ROSE (Continued)

15 Q Good morning, Professor Yarrow.

16 A Good morning.

17 Q You appreciate you are still under the oath that you took yesterday?

18 A Indeed, yes.

19 Q You said yesterday in your evidence that Ofcom had recognised that BT was not recovering
20 sufficiently from its prices for terminating and trunk segments combined and for that reason
21 it permitted BT to increase its prices for terminating segments. Do you remember saying
22 that?

23 A That was in relation to the 2009 price control.

24 Q Yes. Can we just see how this fits into your argument? Can you take up your second
25 report, which is in the core bundle, CB2, tab 26. If we go to page 733 ----

26 A Yes.

27 Q -- we see your comments on the RBB report, that is Mr. Ridyard's report which is relied on
28 by the communications providers, is it not?

29 A Yes.

30 Q And your second comment starts at para. 72:

31 "Secondly, the RBB report argues that there are problems associated with the
32 aggregation of products inside and outside of a price cap when making assessments
33 of overcharging. While we agree with this as a general proposition, we note that

1 much will depend on the nature of the specific price cap arrangements and,
2 critically, *on the level of the price cap that is set in the first instance.*

3 Specifically, where the level of the price cap is set at too low a level, which does
4 not allow a firm to get even close to recovering its efficiently incurred costs from
5 the products within the price cap, then the argument no longer holds.”

6 Does that remain your position?

7 A Yes, it does, although listening to you read it, let me make it clear that 73, the first sentence,
8 is meant to be an example. It’s not a statement of fact. The point is, we are agreeing with
9 Mr. Ridyard’s point in general, though we are trying to point out that, as always, the effects
10 of any policy in relation, say, to trunk will depend upon what the price cap level actually is.
11 It depends upon the factual matter. This is to give an example of a factual – not a factual
12 situation, but to give an example of this situation where there would be a problem.

13 Q Then you go on to consider the actual situation in this case, do you not, and specifically –
14 we see the error you make at 75, and I understand that that was simply a misreading of the
15 figures.

16 A Yes.

17 Q But you still maintain the position that you say BT was under-recovering in relation to trunk
18 and terminating considered together; and then at 76 you refer to the 2009 Leased Lines
19 Charge Control Statement – do you see that?

20 A Yes. Can I just, for clarity again, point out that 75, I believe I’m correct in saying that, yes,
21 those are figures for terminating services only.

22 Q Yes, that is right. You are right, I am sorry. At 76 you say:

23 “The fact that the initial level of the price cap for terminating services has
24 historically been set too low is recognised by Ofcom in the 2009 LLCC. In that
25 document, Ofcom introduced a one-off rebalancing of the level of price for
26 terminating services to reflect the fact that the charges were ‘*materially out of line*
27 *with the underlying costs of provision*’. The changes to terminating prices are
28 substantial and include the doubling of the prices for all 64 kbit terminating
29 services (which is by far the greatest volume of terminating services sold).”

30 A Yes.

31 Q Yesterday in your evidence you referred specifically to para.4.183 of the Ofcom 2009
32 Leased Lines Charge Control Statement, did you not?

33 A I did, from memory. Whether that number is exactly right we will find out now.

34 Q Let us just take a look at it.

1 MR. READ: If it helps my learned friend, just for the transcript reference, it is also in BT3 at tab
2 12.6.

3 MISS ROSE: If we start with the reference that you give in your second report, if we could just
4 go back to p.735 that we were just looking at, there is a footnote 28 where you reference
5 para.4.177. Do you see?

6 A Yes.

7 Q That refers to para.76, where you say:
8 “Ofcom introduced a one-off rebalancing of the level of price for terminating
9 services to reflect the fact that the charges were ‘*materially out of line with the*
10 *underlying costs of provision*’.”

11 A Yes.

12 Q And you refer there to para.4.177?

13 A Yes.

14 Q If we turn that up, p.117 of this extract, Ofcom say there that they:
15 “... have generally preferred RPI-X regulation using ‘glide paths’ ... [because it]
16 leads to greater stability and predictability ...”

17 A Yes.

18 Q Then they say:
19 “However we also recognise that in some cases one-off adjustments to starting
20 charges may be required, if, for example, these charges are materially out of line
21 with the underlying costs of provision.”

22 That is the part that you were relying on. Then, if we come to 4.182 on the facing page,
23 118, there is the heading, “*BT notified the one off price increases*”, and what happened here,
24 as I think we can agree, is that BT notified Ofcom of some one-off increases to particular
25 charges that it said were necessary to enable it to make a reasonable return – is that correct?

26 A I believe that is correct.

27 Q And they specified particular charges to which they were requiring amendment?

28 A Indeed, and I think from recollection they were the charges where there were issues
29 between the relationship between prices and DLRIC. In other words, the prices were ----

30 Q Too low?

31 A -- too low.

32 Q And we see this at 4.182:
33 “On 3rd June 2009 BT notified the one off increases to the prices of some sub
34 2Mbit/s and 2Mbit/s circuits which will become effective from 1st September

1 2009. the notified prices are listed in Table 4.6 below, and these are at the levels
2 we had discussed in our December Consultation.

3 We are not introducing further amendments to these charges. By increasing the
4 price of these services up to the level of the 2007/08 DLRIC values as per BT's
5 RFS's the prices are better aligned with the underlying costs of provision, and give
6 CPs the correct pricing and investment incentives."

7 So Ofcom had accepted BT's argument, had it not?

8 A Yes.

9 Q Then there are two bullet points, and the first says that they are not phased in, it is a one off
10 adjustment?

11 A Yes.

12 Q And then: "BT also notified increases to the price of 2Mbit/s local ends". Those are the
13 final terminating parts of the 2Mbit/s circuit, are they not?

14 A Yes.

15 Q "In our view these price increases are justified to ensure that the price of these services is
16 better aligned with the underlying costs of provision." So this is the passage, is it not, that
17 you were relying on when you gave your evidence yesterday and you referred us to
18 para.4.183, is that right?

19 A It was the paragraph I was referring to, yes.

20 Q I completely understand why you refer to it because in this paragraph Ofcom does indeed
21 say, as you pointed out, that the price of the 2Mbit/s local end was not correctly aligned
22 with costs and that an increase in price was justified to ensure the price was better aligned
23 with underlying costs, yes, which is your point, is it not?

24 A It is one of the points, yes.

25 Q And we then see that there was a reference there to table 4.6?

26 A Yes.

27 Q And you see table 4.6 at p.120?

28 A Yes.

29 Q And these are the one-off alterations to prices?

30 A Yes.

31 Q The first three relate to 64kbit/s segments, do they not?

32 A Yes.

33 Q They are different circuits from 2Mbit/s circuits are they not?

34 A Yes.

1 Q So that if we are asking the question that you postulated yesterday, what does the customer
2 buy? The customer buys a 2Mbit/s circuit, or a 64kbit/s. So the ones that are relevant for
3 us to look at are the 2Mbit/s prices in this table. First of all there is the 2Mbit/s local end,
4 yes?

5 A Yes.

6 Q And we can see that the current price is £691, the notified price, so this is BT's requested
7 increase to that, £833, final price £663, so it is reduced by the amount of the new point of
8 hand over rental charges, so we do not need to worry about that, but they have effectively
9 accepted BT's request for an increase for the 2Mbit/s local end segment, have they not?

10 A I believe that is correct.

11 Q And we also see a decrease in the 2Mbit/s trunk ----

12 A Yes.

13 Q -- immediately below, £102.24 down to £46.83 - yes?

14 A Yes.

15 Q So this is the decision that you rely on as demonstrating that BT's prices for the 2Mbit/s
16 terminating segment were too low, and that therefore you have to aggregate the two in order
17 for BT to make a decent return overall on the 2Mbit/s circuit - correct?

18 A I wouldn't have put it like that. Our principal argument was that the supplies that were
19 made through the relevant period to the CPs were made at prices which did not cover the
20 fully allocated cost including a normal rate of return on capital.

21 Q On the terminating segments?

22 A On the combined, what they ----

23 Q But the specific reason for that is the ----

24 A What they actually sell.

25 Q Yes, but the specific reason for that is the under pricing of the terminating segments?

26 A Well under pricing or over pricing ,the revenue flow is determined by the two prices,
27 whether it is under or over priced is a question of judgment. I am pointing out that
28 essentially in 2009 the argument that BT had put forward first, as you mentioned yesterday,
29 in 2004 had, from my reading, after the accounts were clarified ----

30 Q Been accepted?

31 A -- been generally accepted by Ofcom and that Ofcom recognised this in the rebalance of the
32 tariffs. So my point is this, is to indicate that it seems to me that from this evidence Ofcom
33 itself recognised the issue, and in particular what interested me was the fact that Ofcom
34 itself said if prices were to be phased in then the ROCE would be below the WACC.

1 Q Yes, now are you aware of what happened to that decision of Ofcom's?
2 A I gather there was an appeal, but I have not followed the appeal.
3 Q Are you aware what the outcome of the appeal was?
4 A No.
5 Q The appeal was brought to the Competition Appeal Tribunal and these particular matters
6 were referred to the Competition Commission – is that a procedure you are familiar with?
7 A Yes.
8 Q So the Competition Commission, as the expert body, examines the level of pricing as a
9 price control matter, under the Act.
10 A Yes.
11 Q But you say you are not aware of the result of the appeal?
12 A No, I gather it has been fairly recent?
13 Q Yes, well can I just show you the determination of the Competition Commission on this
14 issue. You can see from the cover sheet it is not actually that recent, it is 30th June 2010?
15 A Yes.
16 Q So you would actually have had plenty of time, would you not, Professor Yarrow, to get up
17 to speed with this?
18 A Well, this is not my main line of business.
19 Q True, but you were relying on the Ofcom 2009 decision in your report, were you not?
20 A Well I think the report was written – when was the report written?
21 Q 12th May, so you knew that there was an appeal underway at that stage, I imagine?
22 A I was vaguely aware there was an appeal underway.
23 Q Do you not think it would have been appropriate to check the outcome of that appeal before
24 you gave evidence?
25 A No, it is not crucial to our main argument.
26 Q I see. Well let us take a look, para. 3.63. there is a reference there to Reference Question
27 2(aa) and the question before the Competition Commission under Reference Question 2(aa)
28 was whether Ofcom had erred in permitting increases to starting charges including the
29 charges we have just been looking at, the increase to the charge for the 2Mbit/s local end.
30 At 3.65 they say:
31 “For the reasons given below, we conclude that Ofcom erred in permitting the
32 increase to 2 Mbit/s local end prices as part of the one-off adjustments to starting
33 charges for the reasons set out at paras. 12-29 of the Reply.”
34 - that is referring to Cable and Wireless's reply to the appeal – do you see that?

1 A Yes.

2 Q So they reversed Ofcom's decision. Look at the reasons why they did that. If you go to
3 page 3-13, para. 3.73 they say:

4 "On 3 June 2009 BT notified the new prices for the TISBO services subject to
5 one-off price adjustments."

6 - and these are the prices we have just looked at, at table 4.6 of the Ofcom decision.

7 "Ofcom explained that by decreasing the price of 2 Mbit/s trunk to the 2007/08
8 DSAC values, as per BT's RFS, prices were better aligned with the underlying
9 cost of provision. Ofcom also explained that the DPCN services and 2 Mbit/s
10 local end price increases were up to the level of the 2007/08 DLRIC values as per
11 BT's RFS and this aligned prices for those services more closely to the underlying
12 cost of provision and gave CPs the correct pricing and investment incentives.

13 However, Ofcom later explained that the 2 Mbit/s local end price increase in fact
14 brought the price of this service above FAC based on Ofcom's calculation of
15 costs."

16 Then if we go to 3.76, there is a summary between paras.3.76 and 3.92 of the arguments
17 that were set out by Cable & Wireless in its reply, which, as we have already seen, are the
18 arguments that were accepted by the Competition Commission. If you look at 3.77, we see
19 Cable & Wireless asserting that:

20 "... it was only the alleged lack of cost orientation that was said to, or could,
21 reasonably justify step changes ... Ofcom admitted that 2 Mbit/s local end prices
22 had already been within the DLRIC floor and DSAC ceiling without any
23 adjustment.

24 ... even if Ofcom had been correct to assess the starting charges only in terms of
25 the effect at a basket level, Ofcom had erred in allowing a 'rebalancing' between
26 trunk and terminating segments. This allowed BT to continue earning excessive
27 profits that it had only been able previously to achieve as a result of exercising its
28 market power in pricing 2 Mbit/s trunk in breach of BT's cost orientation
29 obligations."

30 We see the argument go on. Then there is Ofcom's response. Interestingly, if you go to
31 para.3.110, we see BT's intervention, where BT said:

32 "... that whilst it had serious concerns about Ofcom's reliance on DLRIC and
33 DSAC as the applicable floor and ceiling for determining prices of terminating

1 segments and trunk services, it made no challenge to Ofcom's approach of
2 bringing costs in line with this floor and ceiling in this appeal."
3 So BT accepted DLRIC and DSAC in that appeal – do you see that?
4 A Yes, because of course you are now dealing with price control not with deregulated prices,
5 which trunk were until this price control.
6 Q If you go to p.3-22, "*Justification in the context of the objective of cost orientation*" – do
7 you see that?
8 A Yes.
9 Q "We note that there is no dispute between Ofcom and C&W that the price of 2
10 Mbit/s trunk was above DSAC, that the price of DPCN services was below DLRIC
11 and that the price of 2 Mbit/s local ends was within the DLRIC-DSAC range...
12 The adjustments to the price of 2 Mbit/s trunk and the price of DPCN services
13 were therefore justified as being necessary in order to meet the objective of cost
14 orientation, i.e. ensuring that those services were not priced at levels which posed a
15 risk of distortion of competition."
16 Just pausing there, the Competition Commission has accepted that because the 2 Mbit/s
17 trunk segment price was above the DSAC ceiling, that has justified a one-off reduction to
18 bring it down, has it not?
19 A It has, in the context of price control.
20 Q That is not what it says. It says:
21 "... in order to meet the objective of cost orientation, i.e. ensuring that those
22 services were not priced at levels which posed a risk of distortion of competition."
23 That is the test that the Competition Commission is applying – yes?
24 A Yes.
25 Q And it is accepting that that is a justification for reducing the price of trunk segments, 2
26 Mbit/s trunk – yes?
27 A Yes.
28 Q To the DSAC ceiling?
29 A Yes.
30 Q However, the one-off adjustments together could not be justified if considered
31 solely by reference to the cost orientation objective, since 2 Mbit/s local ends ..."
32 That is the terminating segment – correct?
33 A Yes.

1 Q "... were already priced within the DLRIC and DSAC boundaries and therefore the
2 adjustment to the price of that service goes beyond what is necessary for cost
3 orientation reasons."

4 Do you see that?

5 A Yes.

6 Q Then at 3.132 we see more arguments from Cable & Wireless, the point being made by
7 Cable & Wireless that:
8 "... there was no justification for what was, in its view, 'rebalancing' following
9 reduction of 2 Mbit/s trunk charges... C&W asserted that it had not been shown
10 that the last price control ..."

11 That is the 2004 price control, is it not?

12 A Yes.

13 Q "... had failed to permit BT to recover its efficiently incurred costs and a
14 reasonable rate of return across the TI services that had been subject to a price
15 control (i.e. excluding trunk). It could therefore not be said that there had been a
16 'need' to rebalance."

17 Just pausing there, Cable & Wireless are arguing that it has not been shown that the price of
18 terminating segments subject to the last price control was too low to enable BT to recover
19 its efficiently incurred costs and a reasonable rate of return – correct?

20 A Well, can I read it, because ----

21 Q Yes, please read the paragraph again.

22 A -- it says, "We agree with Cable & Wireless", but then it explains why.

23 Q Just read para.3132 again and tell me what you think it says.

24 A I want to go on to 3.133, but okay, let me go back. So the context is a discussion of 2
25 Mbit/s trunk charges, which is one component, one of a number of components of
26 terminating segments.

27 Q No, it is not a terminating segment, is it?

28 A Sorry, trunk.

29 Q What Cable & Wireless are saying is that there is no justification for rebalancing following
30 a reduction of the 2 Mbit/s trunk charge?

31 A Yes.

32 Q And they say that it has not been shown that the last price control, the 2004 price control:

1 “... had failed to permit BT to recover its efficiently incurred costs and a
2 reasonable rate of return across the TI services that had been subject to a price
3 control (i.e. excluding trunk) ...”

4 So what Cable & Wireless are saying is that had not been shown that the 2004 price control
5 for terminating segments, excluding trunk, did not permit BT a reasonable rate of return –
6 correct? That is what Cable & Wireless are saying.

7 A In relation to the 2004 price control, yes.

8 Q Yes, that’s right. Therefore, they say, it could not be said there had been a need to
9 rebalance. Then they say:

10 “We agree with C&W: Ofcom has not demonstrated that the increase to 2 Mbit/s
11 local end prices as part of the one-off adjustments to starting charges was
12 necessary for promoting efficiency.”

13 A Yes.

14 THE CHAIRMAN: Miss Rose, I am conscious that Professor Yarrow has not read this
15 document. Was that all you were going to take him to, or would it be appropriate to give
16 him, as it were, a reading list of paragraphs that he should think about on his own?

17 MISS ROSE: Can I just take him to some more specific paragraphs and then perhaps if he would
18 like a few minutes to consider them.

19 A Could I just say something at this stage? These are references to the 2004 price control, and
20 you remember the issue of the 2004 price control, there was a great deal of controversy
21 about the actual accounting. Indeed, that was Ofcom’s position at the time, that BT had not
22 shown sufficient reason why there should be rebalancing. The point – to come back – we’re
23 making is that Ofcom did not at that time, on the basis of that information, which is the
24 2004 price control, which is what the Competition Commission is looking at, did not have
25 the impact, and it said so. Later on, there was the change in the accounting system. When
26 we come to the 2009 price control, my point is that Ofcom accepted the rebalancing that
27 was required in order for the terminating and trunk services combined to be making a
28 reasonable rate of return on capital. What we are looking at here are individual components
29 which contribute to the revenues. My understanding – you will correct me if I am wrong,
30 Miss Rose – is that in the 2009 price control there was about £55 million worth of
31 rebalancing. So that was reflecting this adjustment that was being taken. It was appealed.
32 Miss Rose is right, I have not looked at it in detail, we’ve been doing other very interesting
33 things in the time since June. In one press release I saw, one press report, it suggested that
34 while the Competition Commission had found against Ofcom on one or two points, and this

1 is a specific charge, it found in favour of Ofcom on many other points. The effect of that
2 appeal decision – I don't know whether this is authoritative or not, because, as I say again, I
3 haven't read it, but the press release said, "Don't get excited, boys, it's worth about £4
4 million". If that's the case, if this reverses £4 million of the £55 million, it would give a
5 rebalancing of £51 million overall, and that was essentially in our para.75 of the second
6 report where we corrected the figures. The implication of that correction was that for that
7 particular year the imbalance was about £50 million. If I read the numbers correctly, what
8 they come to is a number of about £50 million for the rebalancing, which is a little bit less
9 than was being proposed by Ofcom, but nevertheless is a substantial amount, and on our
10 numbers would take care of the amount that was required in this particular case, and
11 paragraph 76 is concerned with terminating, to get terminating to a normal rate of return on
12 capital. Of course, the rebalancing on the trunk side, since trunk was coming within the
13 price control, trunk prices were being reduced. This is price control now, we have moved
14 backwards. The deregulation has been aborted. You would expect to see that Ofcom, I
15 think, would have been setting trunk prices and caps for trunk prices at around a level which
16 gave a normal rate of return there.

17 THE CHAIRMAN: Professor Yarrow, forgive me, the purpose of my intervention was simply
18 this: I understood from what you said earlier that, for whatever reason, you had not looked
19 at this document. I just wanted to be sure that you were happy to proceed in dealing with
20 Miss Rose's questions without reading, as it were, some of the paragraphs on your own. If
21 you are happy to proceed on that basis, then ----

22 A I am trying to explain why this does not cause me any particular difficulty at the moment.
23 Miss Rose may say something in a moment which does, in which case I may – can I take
24 back to you at that stage and ask for time.

25 THE CHAIRMAN: Let us put it this way, if you want to read any paragraph to which Miss
26 Rose takes you, then do take your time and read it.

27 A Thank you.

28 MISS ROSE: Professor Yarrow, let us just unpick what you have just said. There was only a
29 rebalancing of two services in relation to the 2 Mbit/s circuits in the 2009 Leased Lines
30 Charge Control, was there not? Can you go back to that document.

31 A To that table?

32 Q The table 4.6, yes.

33 A Yes.

34 Q Only two charges rebalanced in relation to 2 Mbit/s circuits?

1 A Yes.

2 Q We have already agreed that it is the 2 Mbit/s circuits that are what we are looking at –
3 right?

4 A Well, no, the whole point of the arguments and the points that Chris and I are making is that
5 you can't consider things very narrowly. You have to look at prices as a whole.

6 Q Professor, yesterday you said that you have to look at what the product is that the customer
7 is actually buying – right?

8 A Yes.

9 Q The customers buy a 2 Mbit/s circuit, do they not?

10 A Along with other things.

11 Q They may or may not buy other things, but the particular product is the 2 Mbit/s circuit?

12 A As I understand it, everybody buys the trunk anyway. The trunk element of the 2 Mbit/s
13 services buys something else as well, which is again one of the central points that people are
14 buying bundles.

15 Q Nobody ever buys 2 Mbit/s trunk with 64 kbit terminating segment, do they?

16 A No, no, but they would buy it with other terminating segments.

17 Q So looking at the 2 Mbit/s charges, there were two that were rebalanced?

18 A Yes.

19 Q One was the trunk?

20 A Yes.

21 Q Which was significantly reduced to the DSAC ceiling?

22 A Yes.

23 Q And that decision was not appealed, or in any event was not altered by the Competition
24 Commission – correct?

25 A Correct.

26 Q The other was the 2 Mbit/s terminating segment, which was sufficiently increased by
27 Ofcom – yes?

28 A Yes.

29 Q And that decision was reversed by the Competition Commission?

30 A Yes.

31 Q And the reason it was reversed by the Competition Commission was that the Competition
32 Commission did not accept the argument that BT was under-recovering its efficiently
33 incurred costs for 2 Mbit/s terminating segments and was not receiving a reasonable rate of
34 return – correct?

1 A I believe that's correct.

2 Q Just for the sake of completeness, we can see the conclusions at paras.3.139 to 3.140 where
3 the Competition Commission say:

4 "Therefore, in our view Ofcom did not have any proper basis for concluding that
5 the increase to the price of 2 Mbit/s local ends was necessary to 'rebalance' for the
6 reduction to the price of 2 Mbit/s trunk or otherwise to preserve the regulatory
7 understanding, i.e. in order to maintain the dynamic efficiency incentives of the TI
8 basket going forward.

9 We therefore find that Ofcom was wrong to conclude that the increase to 2 Mbit/s
10 local end prices, as part of the one-off adjustments to starting charges, was justified
11 by reference to, or proportionate to, the need to maintain the incentive properties of
12 the charge control applicable to the TI basket."

13 Then, if you go forward in the document to para.3.203, p.3-36, there is the final conclusion
14 of the Competition Commission on this question. Can we now come back to your first
15 report, which is in core bundle 2, tab 25, para.138. Just to put this in context, if you go back
16 one page you will see the heading, "*Why no entry?*"

17 A Yes.

18 Q You are making the point that if prices for trunk were excessive you would expect to see
19 entry into the trunk market by other CPs?

20 A Can I go back and read?

21 Q Yes, please do, from para.135 to 138.

22 A (After a pause) Yes, so the issue that we are looking at is how Ofcom assessed entry
23 conditions?

24 Q Yes. I can understand the point that you are making that if you have a competitive market
25 and if one supplier is charging an excessive price you would expect other people to come
26 into that market and undercut them?

27 A You would hope that would happen, certainly, yes.

28 Q You make the point at 138 that there may be an exception to that if there are significant
29 barriers to entry into that market?

30 A Yes, and that would obviously be something that a regulator would be interested in.

31 Q You say at 138:

32 "If there are genuine barriers to entry on a scale such as might justify the
33 abandonment of trunk charge liberalization then in our view Ofcom should have
34 been able to point to them in its Determination. The existence of such barriers

1 would not constitute proof of excessive pricing, but it would at least have
2 established that the economic context is one in which excessive pricing is feasible
3 and economically rational. There is, however, no evidence of the existence of such
4 entry barriers. Ofcom did ask companies why they did not enter, only to be told
5 that the companies expected that Ofcom would lower trunk prices.”

6 A Yes.

7 Q Is it your evidence that there is no evidence of the existence of entry barriers to the trunk
8 segment market, Professor Yarrow?

9 A It is that there is no evidence presented by Ofcom in the determination of any substantial
10 entry barriers. There are always entry barriers at some level in markets, but what we’re
11 interested in is whether barriers to entry are substantial enough to give rise to real and
12 substantial amounts of market power. There is a quantitative assessment.

13 Q You are saying that Ofcom has failed to make that assessment – is that right?

14 A To any acceptable level, yes.

15 Q You return to this point in your second report, when you are responding to Mr. Ridyard’s
16 report, if you go to tab 26. At para.57 you make the point that:

17 “... clearly on the facts, trunk PPC segments are not a natural monopoly. The
18 relevant services are provided, on a significant scale, by parties other than BT ...”

19 Here you refer to the 2008 BCMR consultation.

20 A Yes.

21 Q That is the Business Connectivity Market Review, is it not?

22 A Yes.

23 Q Is that the document that you said you had not read but that Dr. Decker had?

24 A That’s right.

25 Q But you do take responsibility for this report, do you not?

26 A I do, absolutely.

27 Q “... estimated a market share for BT of between 58% and 86%. In addition, BT’s
28 share of terminating segment services is significantly higher than its share of trunk
29 segments, indicating why it was that, in 2004, Ofcom took the view that network
30 competition in this area (trunk) was sufficient not to impose an explicit price cap.”

31 In the same statement you return to this point when you are commenting on Mr. Ridyard’s
32 report. If we go to para.70 you say:

33 “The first issue relates to the suggestion in the RBB report that the trunk network
34 is a natural monopoly, and that this explains the observed lack of entry into the

1 trunk market. We have already discussed this issue at paragraphs 55-57 above.
2 However, to re-state our position, we are sceptical that the evidence which shows a
3 market share for BT of 58% to 86% of the trunk market credibly sustains such an
4 argument.”

5 In fact, Mr. Ridyard had not said that the whole of the trunk market was a natural
6 monopoly, had he? That is an over-simplification of what he said in his report. Will you
7 accept that?

8 A Well, it wasn't terribly clear to us what he said in his report because ----

9 Q Shall we just see what he did say. It is at tab 30, p.785, p.20 of the internal numbering. He
10 says at para.68:

11 “Ofcom’s subsequent decision ...”

12 that is the decision in 2009 that we have just been looking at, is it not?

13 A Yes.

14 Q “... to place the provision of trunk segments into the new charge control basket,
15 and its determination that BT enjoys market power over the provision of such
16 capacity, reflects the realisation that large parts of the trunk network exhibit natural
17 monopoly characteristics.”

18 He is not saying the whole of the trunk network, is he, he is saying large parts of it?

19 A Well, it's actually a statement about Ofcom. It's his interpretation of Ofcom's decision. I
20 doubt that that would be right, because I would think that Ofcom wouldn't think this was a
21 natural monopoly, or even large parts of it were a natural monopoly.

22 Q We will look at that in a minute, but just to be clear, in your second report, you
23 characterised Mr. Ridyard as saying that the whole trunk market was a natural monopoly,
24 but in fact we can see that he was saying large parts of it were. If you go back, it is para.70
25 of your second report?

26 A This is why it is unclear, because – let me deal with the issue. What we have is a network.
27 There will be various bits of the network where it will be easier for a CP to replace or
28 substitute for a part of BT's network, but in other places it will vary by location, and each
29 part will be very specific. If we define a product or a service that product or a service is not
30 defined by the individual locations. That product or service, if it is a trunk service, applies
31 to trunk services right throughout the whole country. If, for example, 50 per cent of these
32 connections are open and you define the product without reference to geography that is
33 simply not a natural monopoly, because if you price up you will lose 50 per cent of your
34 market. Competition always works at the margin, it's the marginal effect of raising prices.

1 If we take the products as given, and again I say you take the facts as they are, as given,
2 then the defined service is not a natural monopoly on these market shares, because parts of
3 it are open and so you will lose parts of your business if you raise the price.

4 Q Let us have a look.

5 A Can I just finish. If you define products separately and price them all separately, so if there
6 was a separate price in BT's list for all these things some of them would be natural
7 monopolies, and that is why I think Mr. Ridyard – he may be asked this but I think you
8 would find us in total agreement with that.

9 Q Well let us have a look at what Ofcom actually decided about the trunk market. The first
10 place we need to look is the 2004 decision, which is the decision that imposed condition H3
11 itself, and you will find that in ADB2 tab 3. If you could turn to p.338. You see the
12 heading: "Market for Wholesale Trunk Segments in the UK"?

13 A Yes.

14 Q And a summary of the conclusions at para. 99:

15 "Ofcom considers that BT has SMP in the market for trunk segments. Ofcom has
16 reached this conclusion based on an analysis of:

- 17 * the ubiquity of BT's infrastructure and number of routes subject to
- 18 little or no competition;
- 19 * barriers to entry;
- 20 * economies of scale;
- 21 * the relatively high percentage of terminating segments with which
- 22 trunk segments were purchased from BT (especially given the charges
- 23 set by BT);
- 24 * BT's vertical integration; and
- 25 * Information supplied by BT suggesting that trunk segments are
- 26 currently priced significantly above cost."

27 Do you see that?

28 A Yes.

29 Q So those are the factors that Ofcom relied on in determining in 2004, when it set the
30 condition that is the subject of these proceedings, that BT had SMP?

31 A Yes.

32 Q BT did not appeal those conclusions, did it?

33 A No.

1 Q Let us just have a look at some of the points that are made. Page 340: Ofcom refer to BT's
2 pricing under the heading "Excess pricing and profitability", do you see that?

3 A Yes.

4 Q And Ofcom include an extract from BT's 2002/03 financial statements, do you see that?

5 A Yes.

6 Q Including the references to the LRIC floor and SAC ceiling. We all agree that that is
7 DLRIC and DSAC, do we not, that is from the Regulatory Financial Statements?

8 A I infer that it is, yes.

9 Q And we see that there is an excess over DSAC. What is said at B.110 is:

10 "Ofcom is not familiar with the precise way in which the above figures were
11 calculated by BT. At first sight though, the fact that BT is able to price trunk
12 segments at a level that is a long way above the level of fully allocated cost, and
13 also well above standalone cost, is consistent with BT enjoying SMP ... Ofcom
14 notes that at such prices BT has still sold trunk segments with around 56% of
15 terminating segments. This suggests that other communications providers are
16 unable to quickly switch to the use of trunk segments that are either self-provided
17 or supplied by another competing operator.

18 This is further reflected in BT's charges for trunk segments. A comparison of the
19 per kilometre charges for PPC terminating segments (which should be priced at
20 cost) and trunk, indicates the trunk charges are up to four times higher. Ofcom
21 would expect trunk charges to be lower than those for terminating segments."

22 And at B.112:

23 "The above data may not provide conclusive evidence on its own without further
24 investigation. Nevertheless it suggests to Ofcom that BT is able to price
25 independently of its competitors, and as such is in a position of SMP."

26 So that is the first point made there, about excess pricing, yes?

27 A Yes.

28 Q Then moving on in the section, you see "Control of infrastructure not easily duplicated" at
29 para. B116. Here Ofcom is talking about maps of the networks of the different CPs, do you
30 see that. They say:

31 "Based on this information, it is clear that a number of such networks have now
32 been built. In particular, many other communications providers have points of
33 presence linking to the UK's major cities, such as London, Leeds, Manchester and
34 Birmingham. However, a number of other areas do not, based on the examination

1 of these maps, appear to have been covered by the rollout of other
2 communications providers' networks."

3 Then if we go on in the bundle, they refer to various different issues, economies of scale,
4 economies of scope, vertical integration and then at p.352 do you see the heading:

5 "Wholesale trunk: market related criteria"?

6 A Yes.

7 Q And the heading: "Ease of market entry"?

8 A Yes.

9 Q So this is where Ofcom discusses barriers to entry, is it not?

10 A In this document, yes.

11 Q It said:

12 "Evidence supplied to Ofcom by BT (such as the maps described in this Annex)
13 shows that many inter-city routes have already been built by a number of
14 communications providers. It seems less likely that building out on the remaining
15 routes will occur, since these are typically routes where traffic density is lower.
16 Ofcom's view is that the self-provision of trunk segments by other
17 communications providers is unlikely to be viable in many cases due to the very
18 significant capital expenditure required to dig duct and install fibre and equipment.
19 Given the small retail market shares that many other communications providers
20 currently have ... this may be uneconomic. BT's status as a former monopoly,
21 and its large traffic volumes, mean that this rollout has been economic for BT.
22 Ofcom has been unable to obtain a usable estimate of the cost to other
23 communications providers of extending trunk network capacity beyond current
24 levels, due to the highly bespoke nature of such projects. However, it seems
25 certain that the sunk cost required would often be very significant as would the
26 amount of time required to complete such a project. This suggests to Ofcom that
27 the prospect of competition developing on less dense routes on a forward-looking
28 basis is limited within the time frame relevant to this review."

29 Then at B.166, under the heading: "Absence of potential competition" they say new market
30 entry is extremely unlikely:

31 "... or that existing players will choose to expand their trunk network capacities
32 beyond the areas currently served. This is discussed in the section on barriers to
33 entry above."

34 Then "Barriers to expansion", para. B.169:

1 “Ofcom believes that the importance of barriers to entry in markets for trunk
2 segments is such that it is not essential to consider further constraints provided by
3 barriers to expansion. This is because competition in wholesale markets appears
4 unlikely to extend beyond the existing market players for the reasons outlined in
5 the discussion of barriers to entry.”

6 Do you see that? Then the conclusion is over the page at 354. The conclusion is that BT
7 has SMP.

8 Then at para. B.174 at the bottom of the page: “Likelihood of competition developing in the
9 future”.

10 “Ofcom has considered the potential impact of external factors on this market
11 during the period covered by this review. Ofcom’s view is that there are no
12 developments that would generate sufficient competitive pressures within the next
13 2-3 years to alter the current finding of SMP. This is because the sources of SMP
14 are high structural barriers to entry ...”

15 Do you see that?

16 “... sources of SMP are high structural barriers to entry and because demand
17 conditions and technological progress are unlikely to be able to reduce the strength
18 of these entry barriers in the near future.”

19 Will you accept that the statement in your report that there was no evidence to back up
20 Ofcom’s conclusion of barriers to entry is incorrect?

21 A Well again, I come to the quantification point. Having said all of these things, and these are
22 the normal kind of arguments and statements that you might find in a regulatory document,
23 it is a matter of fact that Ofcom took the decision not to price control these segments. I
24 think personally that was a correct decision because again what we are trying to do is get a
25 transition to more competitive markets. The economic argument is that although there are
26 low density routes where you will probably never see any replacement of BT by other
27 people, what you are doing is bundling low density and high density routes within a single
28 package which is being sold at a single price, so if you move that price up what you get is
29 the cherry picking competition for those particular connections which are profitable, and it
30 is that substitution at the margin which gives you enough leverage to justify taking away a
31 price control. If you did not believe that there was such substitution Ofcom would not in
32 the first place (or shouldn’t) have deregulated. But it has made its judgment that here are
33 the barriers to entry and, as I said before, there are always barriers to entry. I would
34 disagree obviously with the comment there that there were high structural barriers to entry

1 because I would have said if they really believed that they would have reached different
2 judgments, because high structural barriers to entry usually means that you want a price
3 control if you don't have a lot of competition already in the market. So I think that might
4 have been not the most felicitous choice of words by the drafter of this particular document,
5 and having drafted a lot of documents or edited a lot of documents they are not always
6 perfectly drafted.

7 The judgment to deregulate implies a judgment that these barriers to entry are not severe
8 enough to warrant a price control.

9 Q So you place weight on what you see as the regulatory judgment of Ofcom in 2004 to
10 impose cost orientation on the trunk segment market but not a price control?

11 A Precisely.

12 Q Would it follow from that, that if Ofcom had concluded that the barriers to entry were so
13 significant that there was a need for a charge control that that would cause you to revise
14 your view?

15 A Can you say that again? If?

16 Q Yes, had Ofcom made the judgment that the barriers to entry were so significant that it was
17 necessary to impose a charge control on trunk segments that that would cause you to revise
18 your view?

19 A Well it does not cause me to revise my view because we would have been in a totally
20 different context. If Ofcom had so concluded we would have had price control on
21 terminating and trunk segments together, and this case would not have arisen ----

22 Q Your analysis ----

23 A -- so there would have been no view to form.

24 Q Forgive me, but your analysis that this is a market in which there are not such barriers to
25 entry as to suggest that people will not be able to enter the market if BT is over pricing, that
26 judgment would not stand, would it, if Ofcom had made the judgment that in fact there were
27 such significant barriers to entry that you needed a charge control?

28 A The argument in the paper is that Ofcom has not presented any evidence that would suggest
29 that there are the kind of level of barriers to entry that would cause them to worry.

30 Q I am simply asking you, it is an obvious point, that had the evidence been there that Ofcom
31 had concluded that there were such significant barriers to entry that would change your
32 view?

33 A Well if Ofcom had concluded at that time that the barriers to entry were such that price
34 control was required I would not have looked at this case.

1 Q I am not asking you that question, I am asking you about your judgment in terms of whether
2 you would expect market entry if they were overcharging?

3 A My judgment is I would expect some market entry if there was overcharging.

4 Q If Ofcom had made the judgment ----

5 A Yes.

6 Q -- that this was a market in which there were such serious barriers to entry that you needed a
7 price control, would that change your view on that?

8 A It would change my view on the fact that simply overcharging you wouldn't necessarily get
9 entry, if that's what you are asking, yes.

10 Q The decision that is the subject of this particular case, the determination in this case, which
11 is at tab 31, of core bundle 2, if you just look at the front page you can see that decision was
12 reached on 14th October 2009?

13 A Yes.

14 Q Are you aware that as at that date Ofcom had, in fact, made a judgment that there were
15 such serious barriers to entry in the trunk segment market that it was necessary to impose a
16 charge control?

17 A Yes.

18 Q Let us just look at the evidence on that. It is the business connectivity market review
19 consultation, if you can take up ADB4, and if you look at para. 7.351?

20 A Sorry, which page?

21 Q Page 268, behind tab 9. You see the heading: "National market for trunk segments"?

22 A Yes.

23 Q Paragraph 3.751:

24 "Having reviewed the evidence, Ofcom considers that BT has SMP in the national
25 market for trunk services. Our view is based on:

26 * BT's high market share (which appears to reflect not only its own
27 retail operations but also a high share of sales to OCPs);

28 * BT's apparent profitability in this market:

29 * the ubiquity of BT's infrastructure and the number of routes subject to
30 little or no competition.

31 * economies of scale;

32 * barriers which impede OCPs entering or expanding in this market."

33 Before we look at the detail on this, this is of course a consultation paper, and we can see
34 that that conclusion was approved by Ofcom by a further decision in January 2009. If you

1 go to tab 10, para. 7.163, there you see a reference to the paragraphs we have been looking
2 at in the January 2008 consultation, and at 7.175 on p.173:

3 “Our conclusion remains that BT has SMP in the wholesale trunk segments
4 market in the UK for the reasons given in the January 2008 consultation
5 We consider that the SMP that presently characterises the market is likely to
6 remain for the period covered by this review. We have not been able to identify
7 any developments that would serve to reduce the high structural barriers to entry
8 and expansion that characterised the market which would generate sufficient
9 competitive pressures within the relevant time frame to alter the current finding of
10 SMP. In particular Ofcom considers the low rate of growth which characterises
11 many of the retail leased line markets that make use of trunk segments is likely to
12 prevent BT’s wholesale competitors expanding to a scale where they can operate
13 as efficiently as BT.

14 Further, Ofcom is not aware of any other CP having plans to expand its trunk
15 network coverage in the foreseeable future. It appears likely that such expansion
16 would be too costly and time consuming for the prospect of it to provide a
17 substantial constraint on BT’s conduct.”

18 Do you see that?

19 A Yes.

20 Q Now, if we look at some of the detail on the findings on barriers to entry, if you go back to
21 tab 9 and para. 3.374 there is a discussion of BT’s reported profitability for trunk segments,
22 and the point is made that these prices are very high. Then if we go on to 3.80, “Control of
23 infrastructure not easily replicated”, and para. 7.381:

24 “The information suggests that there are various routes over which multiple CPs
25 could (at least in principle) compete. However, (as discussed in our market
26 definition assessment) there are in fact comparatively few routes where three or
27 more CPS (including BT) have trunk capacity.

28 This is consistent with the market share and profitability analyses set out above. It
29 is unlikely that BT would have a high market share and would earn high profits in
30 the market if OCPs were able to compete effectively for trunk capacity. Hence,
31 although many CPs appear to have networks capable of providing core
32 connectivity, the extent to which these networks are used instead of relying on
33 BT’s SDH network appears to be limited.”

34 Then at 7.384:

1 “When purchasing a terminating segment from BT, where a trunk segment is
2 required, OCPs can choose between buying a trunk segment from BT, self-
3 providing or alternatively buying from another OCP. Ofcom expects that where
4 viable, OCPs would generally prefer to self-provide trunk segments. Our market
5 definition analysis however suggests that OCPs, in many cases, rely on BT trunk
6 (at least when providing retail leased lines to customers which also use BT’s
7 PPCs). This suggests that OCPs are unable to either self-provide trunk segments
8 or source them from elsewhere.”

9 And the conclusion at 7.387 is that the data presented still suggests that OCPs still depend
10 significantly on BT for the supply of trunk.

11 Then economies of scale is dealt with, and the point is made about the large up front
12 investments needed to enter this market. At 7.389 the point is made again about inter-city
13 routes that may be profitable but remaining routes not likely to be viable, and the prospect
14 of competition developing on the less dense routes on a forward looking basis is limited.
15 Then there is “Economies of scope”, and they make the point at para.400 that BT provides
16 multiple services and that gives it significant opportunity to exploit economies of scope to a
17 greater degree than OCPs.

18 Then at p.276, para. 7.401:

19 “... the threat of potential entry can prevent firms from raising prices above
20 competitive levels. Ofcom believes, however, that the likelihood of substantial
21 entry by new players in the trunk market is low. Most of the major CPs are
22 already present in this market and (as discussed immediately below) there are
23 significant barriers to entry into this market.”

24 Then “ease of market entry”:

25 “The discussion above indicates there are multiple obstacles to new firms wishing
26 to enter the trunk market, many of which are likely to be substantial. As noted
27 above, the market is characterised by significant economies of scale and scope
28 which enable BT ... to produce at lower average cost than its smaller rivals.”

29 Then the point about sunk costs, an additional barrier to entry, and then “Barriers to
30 expansion” at 7.404: “... barriers to existing players”, this is an important point.

31 “... there are barriers to existing players shifting additional traffic on to their
32 existing network (as may arise for example if an OCP wishes to stop acquiring
33 trunk capacity from BT and instead migrate that traffic on to its own core
34 network). As noted above, such a move could require substantial investments in

1 new interconnect and associated infrastructure. Because of current uncertainties
2 regarding the development of traditional interface services ... OCPs appear
3 unwilling to make these new investments. In short, the risk that the life of these
4 investments could be limited is one factor which appears to impede OCPs making
5 additional use of their existing trunk networks at the present time.”

6 Then at 7.410 they discuss the possibility of OCPs buying trunk from other OCPs. They
7 say:

8 “The configuration of many OCPs’ own networks also makes it likely they will
9 generally use BT’s core network rather than relying on the network of other OCPs.
10 It is often more convenient to buy trunk segments from just one buyer rather than
11 dealing with numerous different entities. As discussed above, interconnection
12 generally requires some sunk costs associated with setting up system interfaces;
13 billing arrangements etc, which unless already incurred would act as a barrier to
14 interconnection. In this regard BT’s core network size makes it the seller of
15 choice.”

16 Then 7.414: “Likelihood of competition developing in the future”:

17 “Ofcom has assessed whether the SMP that presently characterises the market is
18 likely to diminish during the period covered by this review. Ofcom has not been
19 able to identify any developments that would serve to reduce the high structural
20 barriers to entry that characterise the market, which would generate sufficient
21 competitive pressures within the next four years to alter the current finding of
22 SMP.”

23 We know that the result of this review was a decision to impose charge control on trunk
24 segments, was it not?

25 A Yes.

26 Q And that decision was not appealed by BT, was it?

27 A No.

28 Q The decision about SMP and the trunk market?

29 A No. Could I comment to the Tribunal just on a point on that?

30 THE CHAIRMAN: Please do, Professor.

31 A Ofcom reached a decision in 2004 which was a decision consistent with where European
32 and UK policy is trying to head, which is towards deregulation, to get Regulators a bit
33 more out of price determination in these sectors. It reversed that decision in 2008 and the
34 question that we were interested in was: why were things different in 2008 than they were in

1 2004, and what was the reasoning for this, because as Miss Rose correctly says, we were
2 aware that Ofcom had shifted position on this particular fact.

3 Ofcom explains that in the determination and it says that it went out and it asked,
4 specifically asked, the CPs why they had not entered on a larger scale if it was indeed the
5 case that these very large, apparent rates of return were genuine rather than accounting
6 artefacts, or constructions of regulation. So there was the chance for people to put evidence
7 and simply say: “The barriers to entry are too high, you have got it wrong, you
8 underestimated the barriers to entry.” But what is recorded in the determination that the
9 CPs said, is that they said they expected Ofcom to reduce prices. So the CPs were
10 expecting reductions in prices not through investing in new capacity but through getting a
11 decision either through a regulatory route, maybe a price control – what later happened; or
12 perhaps through an appeal to a body like this. This is a classic regulatory dilemma when we
13 have very heavy regulation in a sector, it distracts the attention of business people away
14 from putting investments in and innovating and finding ways around BT’s network and
15 doing all the creative things that generate progress into actually trying to get the reduced
16 prices by some other route.

17 As it turned out, the CPs were absolutely correct in their expectation and when it came to
18 the rebalancing that took place in 2009 the trunk prices were reduced, so why did people not
19 enter? They didn’t enter on this evidence, and this is the evidence presented in the
20 determination, and we were concerned with the determination, that is what we were pointed
21 towards and that was our remit, to comment and give an opinion on the determination. On
22 that basis, if that is correct evidence, the biggest barrier to entry in this market was actually
23 Ofcom’s policy, and it’s a classic problem of regulators not being very keen to let go, and
24 the companies are the same. Rationally, looking at it *ex post* they were right, the prices of
25 trunk segments have come down, so if you are expecting that, that is obviously going to
26 affect your decision. That is what the CPs told Ofcom, that is in the determination, and that
27 is why we say this is all a bit of a puzzle.

28 The other aspect of the puzzle is then when you come to the theory of harm that has
29 developed *ex post* if you really believe you can look at prices and just compare them with
30 costs and say “That is terribly high, what is the possible harm of that? It might be excess
31 entry”. Well if you really believe that there is a natural monopoly and there really are high
32 structural barriers to entry it is very unlikely that excess entry is going to be the harm that
33 will be caused by the high price.

1 All of this to me, as a kind of an old hand in these areas, first of all there are two Ofcoms
2 here – the hands that are involved in this particular case are not necessarily the hands
3 involved in some of those other documents, and there are some divergences of views
4 because all of those passages that Miss Rose read out actually miss what appears on the face
5 of the evidence in the determination to have been the main barrier to entry. The one thing
6 that was different in this later period from the earlier period, which was an expectation of
7 regulatory intervention to reduce trunk prices.

8 MISS ROSE: Professor Yarrow, the determination that is the subject of this appeal was the
9 resolution of a particular dispute, was it not?

10 A Yes.

11 Q Not a market review?

12 A No.

13 Q And the resolution of that dispute took place following a full consultation on the business
14 connectivity market review which we have just looked at, have we not?

15 A Yes.

16 Q And the CPs and BT responded to that consultation, did they not?

17 A They did.

18 Q And following that consultation Ofcom made a finding about SMP including barriers to
19 entry, did it not?

20 A It did.

21 Q Are you suggesting that when looking at the determination of this dispute it is appropriate to
22 ignore all of those findings?

23 A I do not think they are terribly relevant to the way in which the main issues present
24 themselves, because what we are looking at here is something *ex post* and I come back
25 again to the fact that the main point to me in looking at this evidence is the fact that given
26 the price control in 2004 and given the position that that created, that an interpretation of
27 the cost orientation obligation, an interpretation that would lead to a price capping in that
28 period, on that basis at DSAC would leave BT short of its cost of capital on PPCs.

29 Q You made a second point, which was in relation to harm, and you said that if Ofcom are
30 saying there are high barriers to entry then where is the harm going to be because there will
31 not be any inefficient entry? That is what you said, is it not?

32 A I think it's a puzzle. I mean, it's — to be frank, the argumentation is incoherent. So, it's
33 very difficult —

1 Q Now, inefficient entry is not the only kind of inefficient investment that could result from a
2 disproportionately high Trunk price, is it?

3 A Well, perhaps you could explain —

4 Q Yes, of course. If you have a particular communications provider that has to make
5 decisions about where to locate their point of connection.

6 A Somebody already in the market, yes, exactly.

7 Q No, not about expanding, it is about the configuration of their network.

8 A Okay.

9 Q And the places at which it interconnects with BT. Those decisions will be distorted, will
10 they not, by an imbalance between the prices of trunk and terminating segments.

11 A Distorted relative to what? I mean, the point of deregulation is to allow market prices to
12 signal where investment is to go in. Inevitably, in the short term, that is always going to,
13 you know, lead to what a very short term economic theorist would call a distortion, because
14 there is a trade off between static and dynamic factors in this market.

15 Q And you accept, I think, that different communication providers have different types of
16 networks, do they not, so, their reliance on trunk is different.

17 A Their reliance on trunk is different.

18 Q And those who are more reliant on trunk will be impeded in competing with those who are
19 less reliant on trunk if the prices of trunk are disproportionately high, will they not?

20 A In the hypothetical situation in which there is an unjustified differential in that direction,
21 that would certainly affect those who relied more on trunk from BT. And of course the
22 business in the retail market that relies most on BT trunk is BT Retail. So that's why, again,
23 it's a bit of puzzle this case, because what we're normally worried about with an incumbent
24 operator like BT is BT actually using pricing, access pricing, to favour its own downstream
25 business. That would be the case if the price of terminating were high and the price of trunk
26 were low, because BT buys more trunk from its own business, upstream business, than
27 other people. In fact, the price ratio is exactly the reverse and, I may have put this wrong,
28 but I read Ofcom as doing that in a deliberate way in order to stimulate competition and
29 new entry and get people thinking about trunk segments where there was greater scope for
30 people to come in and do alternatives to British Telecom.

31 Q I have no further questions.

32 THE CHAIRMAN: Thank you, Miss Rose. Mr. Read.

Re-examined by Mr. READ

1
2 Q Professor Yarrow, subject to one point you will be glad to know I am not going to ask you
3 too many questions in re-examination. Can I first of all ask you to go to your first report
4 which is in CB2, tab25 I think it is. Paragraph 46 of your first report, which is at tab.25 in
5 core bundle 2 at p.675. Do you have it?

6 A Yes.

7 Q Because in the game of tennis that was going on yesterday, you referred to Professor
8 Hausman in glowing terms, and wanted to make a point on it, but I am not sure whether or
9 not the focus of the point actually came out in the tennis interplay. There is the quotation
10 you are actually talking about there.

11 A That's right.

12 Q What point do you feel that is clear at that quotation?

13 A Thank you. Can I first apologise to the Tribunal for getting involved in the tennis and
14 therefore perhaps contributing to this point being lost at that particular stage. The point is
15 this is a statement I think, within three sentences of what I think most serious economists
16 would sign up to. What Jerry Hausman says is, first of all, the accounting allocations that
17 we do for fixed and common costs, which of course are a big and important costs
18 component of telecoms, and they tend to become more important the smaller the slice of the
19 value added that you take when looking at a particular problem. Those allocations are, as
20 he puts it, "inherently arbitrary". And I think that should be non contentious because if the
21 Tribunal looks back to the previous paragraph, 45, I think Ofcom would agree with what
22 that says

23 "There may be many different ways of attributing these common costs to different
24 services, none of which may be uniquely correct or uniquely reasonable".

25 So, the cost allocation methods themselves necessarily produce arbitrariness. What
26 Hausman is then saying is that nevertheless, we have got to use one of these, or at least do
27 something which is consistent with one of these, and that will affect regulated prices. And
28 that's obvious from the hearing, of course, because what we're arguing about is exactly
29 that. The interpretation of this condition will affect the decision on regulated prices. And
30 he then says:

31 "These regulated prices in turn have important effects on competition, economic
32 efficiency and consumer welfare".

33 Now, in a nutshell, that is why it's my view, a very firm view, that Ofcom's original
34 statement of what it was going to do in this area was very balanced and correct. It said it

1 would use a screening test, well, it didn't say a screening but it used the words "first order"
2 which is obviously potentially confusing. But the primary or principal focus would be on
3 effects. And I think that's good regulation, because what regulation is trying to do is to
4 develop a set of rules that make markets work well. This is not a bureaucratic exercise, it's
5 not an exercise in economic theory; as I said yesterday I'm not a fan of combinatorials
6 because they take people off into all these abstract motions and you lose sight of the main
7 purpose, which is to set rules which make markets work well. And the way to do that is to
8 put the first priority to the effects, and that is again the opinion we reached in looking at it,
9 that that was what Ofcom was not doing, that Ofcom was giving undue weight to DSAC,
10 which is an even more arbitrary concept than most accounting concepts, because at least if
11 we're talking about fully allocated costs or equiproportionate mark-ups in a normal sense,
12 they're standard techniques that have been used worldwide by everybody. DSAC is used
13 only by Ofcom. So, this to me is the economic basis for our finding on why we think
14 Ofcom deviated from its own guidelines — which we think were absolutely aligned with
15 this particular perspective.

16 Q Can I just ask you on that point to take bundle BT3 and take you to tab.12.1, which is the
17 guidelines that you just referred to, and take you to para.3.5. (For the tribunal's reference,
18 this is the 2001 guidelines, it is virtually the same, at para.3.1, so there is no distinction at
19 all as there is not, indeed, in much of the two respective guidelines, but on this point there is
20 no distinction at all). Look at 3.5 and explain how you see that fitting in with what
21 Professor Hausman said.

22 A Well, I think it fits exactly, because it says:

23 "The primary focus of investigation of a complaint will be the effect or likely effect
24 of the charge on competition and consumers".

25 It does introduce, obviously, the first order test which is not something that Jerry
26 Hausman's statement covers, but as a matter of practical regulation regulators need to have
27 screens to weed out a lot of stuff that comes across their desks because, as a regulator, there
28 is always somebody knocking on your door wanting you to do something, and you could
29 allocate large amounts of resources to investigating large numbers of trivial complaints and
30 pleas to do something about something. So, it's very important, actually, as a matter of
31 regulatory practice, it is not a kind of assessment issue, it's a matter of regulatory practice to
32 have a screening process which, particularly for junior and younger public officials, that
33 allows them to say "no" quite frequently to people asking for intervention which is, as I say,
34 is a constant stream of people knocking on the door.

1 Q Just going back to the Hausman paragraph and concentrating a bit more on the first part of
2 it, where he is talking about the allocation of common costs — can I ask you to take bundle
3 ADB2 again, which you had out earlier. If you look at the first tab in that bundle which
4 should be tab.3 I hope, which is the 2004 leased line market review. Do you have that?

5 A Yes.

6 Q And if you go to p.349, this is part of the annexe B that you were taken at by some length
7 by Miss Rose earlier on, but I think para.B142 was not a paragraph that you were referred
8 to. But we see there it says:

9 “Ofcom’s opinion is that the trunk segments market is characterised by large
10 economies of scale. The reason for this is that there exist large fixed costs, for
11 example the costs of supplying duct and cables. Once these large up-front costs
12 have been sunk, the cost to communications providers of supplying larger volumes
13 of individual circuits (or higher bandwidths) is relatively small”.

14 How do you see that in relation to what Professor Hausman said?

15 A Well, it is the large up-front costs which create this common fixed costs problem which then
16 leads to the allocation problem. How are those sunk costs being later allocated to different
17 services, and it is one of the reasons, of course, why it is a particular problem in telecoms,
18 because telecoms does have these types of cost and they account for a large component of
19 total costs. So, the arbitrariness problem looms very large in telecoms, which is of course
20 why Hausman as a telecoms expert is making the point. I mean, it is a feature of the sector.

21 Q Now, you were referred — again at some length — by Miss Rose to the determination of
22 the Competition Commission of 30th June 2010, and I think you said in the course of your
23 cross-examination that in fact that was looking at something different. It was looking at
24 charge controls rather than as such.

25 A Yes.

26 Q Does that make a difference, in your view?

27 A Of course. Again, going back to the fundamental purposes of all of this, it is a managed
28 transition away from the old monopoly position towards competition in networks and
29 network services. So, where you think you are on that particular path will determine the
30 stringency of the requirements. And we had a little discussion about stringency in the
31 interchange with Mr. Saini. So, stringency is a relative term. If you believe that the
32 markets are naturally monopolistic and you have a product which is genuinely naturally
33 monopolistic, you introduce very stringent price controls. Indeed, you try to regulate
34 roughly at the cost of capital, whereas as you move away and move through stages of

1 dominance, significant market power and so on to more competitive conditions, the policy
2 is to relax, to give more latitude, as we kept saying. Now, obviously, if Ofcom (I think
3 wrongly) takes the view that we should go back, that we should abort the deregulation, that
4 policy position reflects a view that we're back near stage 1, right at the start of the process,
5 rather than somewhere further down the line, which is where it would have been looking to
6 when it made the original decision and where I think we actually got to and should be at.
7 And if you're closer to that starting point, you can impose more stringent conditions. It is a
8 different issue because at the end of the day you are regulating in a way which is — if the
9 firm is reasonably efficient — in effect guaranteeing it a rate of return on capital. You are
10 not doing that when you're deregulating. I mean, once you deregulate, the company can
11 make more than its cost of capital or it can make less. That's the whole point. You're
12 putting it into the market.

13 Q Yes, and when you are talking about deregulating there, what context do you mean by the
14 word “deregulating”?

15 A I'm thinking of the general movement from when you withdraw a charge control on an
16 aspect of services and introduce, usually as the first stage, a cost orientation obligation.
17 And then, all being well, it may be that there will come a day, the technologies are moving
18 so quickly, when you won't need even that, and it will be simply competition law.

19 Q You were asked a series of questions about the Competition Commission's determination in
20 respect of specific individual trunk elements, 2 Mbit/s in particular, trunk charges 2 Mbit
21 terminating charges. How relevant do you think that is in the context of looking at a cost
22 orientation obligation generally in the context of this particular situation we are dealing with
23 here, rather than what the Competition Commission were dealing with?

24 A Yes. It's the point you make, that you have already made, that once you move back to price
25 control you've changed the context, and you're changing the criteria and you're changing
26 how intrusive you are. So, in the earlier period, in 2004, for better or worse, Ofcom had
27 taken the decision to effectively lift the price cap on trunk services. So in that particular
28 period, the way you will look at these things is rather different from when you get to a full
29 price control, and anybody who's been through a full price control will know that the
30 Competition Commission, the regulator, goes through matters in great detail, and gets down
31 to all sorts of individual levels of detail which you wouldn't want to do and wouldn't dream
32 of doing if you believe that you are in a more competitive situation.

1 Q And, how do you view the focus in the Competition Commission's determination on the
2 individual segments as relevant to the, for example the Hausman quotation that you have
3 already referred to earlier on?

4 A Well, the Competition Commission, the sections Miss Rose was reading out, were making
5 references to their views that this might have some effect on efficiency, I think I remember
6 that. How well argued or how detailed the argumentation there was from the competition
7 panel, I don't know. I mean, you would need to look at it in detail to see what their
8 preoccupations were and what the issues were. So, there's a bit of that. But, I mean, we are
9 dealing there at a level of detail that is not really relevant very much to the Hausman kind of
10 points, which are much more general points about the problems.

11 Q You mention there efficiency. Can I just ask you this set of points — we know, because if
12 you actually have that bundle, ABD2 still available.

13 A Yes.

14 Q If you go to the fourth tab, tab.4 in that second tab in the bundle (but it is marked "tab.4")
15 we come to the September 2004 final statements on price cap. If you look at para.C33
16 I think it is on p.106, it looks like there, unlike what happened in 2009, that Ofcom has
17 decided to use the current charges as the starting charges for the PPC charge control in the
18 absence of persuasive evidence from BT and the robustness of the model.

19 A Yes.

20 Q So, it looks there as though there has been no realignment of the terminating segment
21 charges. It is all at the existing prices, do you see that?

22 A Yes.

23 Q Can I ask you to take bundle CB1 and ask you to go to tab.6, and if you can go to p.117
24 within that, do you have it? It has got a table.

25 A Yes.

26 Q And it helpfully summarises what the RFS, regulatory financial statements for the year
27 ending 31st March 2002 indicate, and as the text indicates and indeed you can see from the
28 figures, the figures in red show the DLRIC ceiling that the charges are actually under that
29 DLRIC ceiling, and the figures in blue show that they are above the DSAC ceiling and so
30 on. One can see that, for example, just looking at the first two instances, the Connections,
31 we can see that the Component Floor for the 64Kbit PC Connection is 1,445, and the charge
32 is 537. Do you see those figures?

33 A Yes.

34 Q Likewise for the 2 Mbit PC Connection, the Ceiling is 1,863 and the charge is 4,130. Yes?

1 A Yes.

2 Q And if one looks over the page at p.118, we see the same process being done for the year
3 ended 31st March 2004. Do you see that?

4 A Yes.

5 Q And, again, red and blue highlighting the differences. Now, it is clear from that that at that
6 stage a number of the terminating segment charges were below the DLRIC floor.

7 A Yes. Subject to the fact that that is obviously based upon these accounts, yes. I have no
8 expertise at how reliable these accounts are, and I think we know that there were
9 improvements and changes to the accounting methods. So, you are right in relation to the
10 DLRIC floor as calculated by this arbitrary calculation method, probably.

11 Q Yes.

12 A Because DLRIC —

13 Q But, given that the prices are being kept the same what does that suggest to you?

14 A Well, it's an implicit acceptance that these prices are okay. I doubt that Ofcom would
15 necessarily say that explicitly, but if these are transparently laid out and available to it, and
16 Ofcom has as you say simply taken over those prices as the starting prices, particularly
17 given again that this is price control and therefore, price control, you would expect the
18 regulator to pay fairly careful attention to detail. It wouldn't necessarily be a broad sweep
19 kind of approach that would be more appropriate in deregulated sectors. I think you could
20 only infer that there is an acceptance, that these are okay.

21 Q Yes. (To the Chairman) Sir, I am going to have to take a little bit of time (and I am
22 conscious of the time) to find the reference, and I am conscious of the time anyway.
23 I wonder if that would be a convenient moment for the mid-morning break? Sir, the only
24 other point I wanted to make is that, obviously the Competition Commission determination
25 has just effectively arrived on my desk this morning and I have not had a chance to look at
26 it so, more to the point, I think it would be completely tangential, for all the reasons that
27 have been said in the course of the cross-examination, but can I have an opportunity,
28 perhaps five minutes, to actually take some more instructions from those behind me?

29 THE CHAIRMAN: Okay. We will rise for five minutes.

30 (Short break)

31 MR. READ: Just before the short adjournment, we saw that the prices in 2004, the terminating
32 prices were set at the same level for the charge control. Do you remember that?

33 A Yes.

1 Q We also know that the RFS in 2003 and 2004 were showing terminating segments well
2 below LRIC or below DLRIC – yes?

3 A Yes.

4 Q I hope you still have bundle ADB2 open, and if we go to tab 4, which is the second in the
5 bundle, p.6, we see at S.19 Ofcom approach to BT’s relative inefficiency at that stage. Do
6 you see that?

7 A Yes, I do.

8 Q They use a mid-point range of 7.5 per cent – yes?

9 A Yes.

10 Q We know also, because it is in the final determination, that in the period – and I will take
11 you to it if you want to have a look at it – BT’s efficiency substantially improved. Do you
12 want to have a look at the figures on that?

13 A Yes, why not.

14 Q I will take you to CB2, which is the one that has your witness statement in, p.922,
15 para.7.105. You can see that:

16 “... ‘operational inefficiency’ was gradually eliminated over the charge control
17 period and that any adjustments to reflect this are unlike to generate substantial
18 changes to SAC estimates based on BT’s actual costs.”

19 So it is making this point in the context of a debate about combinatorial testing, but it is
20 actually making clear the analysis that has happened.

21 A Yes.

22 Q Having regard to those efficiency figures as to what actually happened, together with the
23 other two points about the terminating prices having been fixed, does that tell you anything
24 about how the product was performing?

25 A I’m not quite sure how you’re putting the question.

26 Q You were asked yesterday about the question of efficiency.

27 A Yes.

28 Q The reference to that is at day 4, p.99. You were asked about these efficiency studies – yes?

29 A Yes.

30 Q The point I want to ask you is what do you think you can gain, what information can you
31 gain from those efficiency studies?

32 A Well, on the basis of what was said then and what was said in 2009, the face reading would
33 be that there was a bit of inefficiency in 2004, that is the 7.5 per cent figure, which is not a
34 large figure in terms of what regulators might find in these circumstances, but it appears,

1 rather unusually, that the 2009 statement concludes that BT is pretty efficient, which is a
2 rather glowing report actually from a regulator in my experience. The one complication I
3 have is, and I hope I mentioned it when Miss Rose was raising the question, of course, the
4 bit that I looked at in terms of the earlier study, the NERA study, was that it was an
5 international benchmarking study. While my view is that you can't ignore international
6 benchmarking evidence, it is reasonable – if it's the best you've got, you use it –
7 nevertheless, as I hope I said at the time we were discussing that in another context, it
8 always has to be interpreted and approached with a little bit of caution. So those earlier
9 figures, I certainly wouldn't endorse them in any way. On the face reading of the two
10 statements it looks like a company that was doing reasonably okay at the beginning. It was
11 performing not too badly relative to the top decile of US companies – the US companies
12 looked pretty good – and has improved since then.

13 Q Finally, can I ask you to go to the 2009 Leased Line Charge Control, which you will find
14 located in BT3, tab 12.6, and it is loose on the desk as well. This is the Leased Line Charge
15 Control Statement for 2nd July 2009. Can I ask you to go to para.4.22. You were asked a
16 series of questions about this particular document, and I just want to see the context to
17 which your answers relate. We can see at 4.22:

18 “In the wholesale definition in the BCMR Statement, we discussed the
19 complementary nature of TI terminating and trunk segments and the greater
20 potential for competition in respect of trunk markets. As many CPs have their own
21 core networks, it will not always be the case that a CP will need to purchase trunk
22 when they require a TI terminating segment.”

23 You can see that there is a footnote there, footnote 53:

24 “In the BCMR statement, we explained that a CP requiring wholesale trunk
25 segments will often purchase this with a TISBO segment. We also highlighted that
26 trunk markets were prospectively more competitive than TISBO. In the case of the
27 latter, access and backhaul elements are generally bottleneck services, whereas
28 there is greater opportunity for CPs to realise economies of scale and scope in
29 trunk markets and they are often able to self-supply trunk circuit segments.”

30 Do you gain anything from that at all in what you were saying earlier?

31 A Well, I think I said that I found the arguments between the different documents on entry
32 barriers incoherent. I think this is an illustration of it. In 2004 Ofcom were saying that
33 trunk – on these arguments, these very arguments – it was prospectively competitive and
34 should be removed from the price control and subject only to the cost orientation condition.

1 That's the regime we had. In the price control document, the trunk segments are taken
2 back, presumably on the argument that something has changed. I mentioned that Ofcom did
3 ask the CPs why they weren't entering and they said, "Because we expected lower prices".
4 Our statement there was that there was no evidence actually that things really had changed,
5 that nothing new had been presented. In this document again, we find this more optimistic
6 view of the future saying that there is a distinction between terminating and trunk and that
7 trunk, as you say, as it says here, is prospectively more competitive than TISBO. Having
8 said that, these are all relative statements. Again, a lot of these regulatory judgments are
9 matters of degree. It is not an illogical position – I think it is a wrong position – for Ofcom
10 simultaneously to believe that trunk is prospectively more competitive still than terminating
11 but nevertheless not prospectively competitive enough to justify removal of the price
12 control. I do have to say that it is a bit all over the place, the analysis of entry and
13 competitive prospects.

14 MR. READ: Thank you, Professor Yarrow? Are there any questions that the Tribunal want to
15 ask?

16 THE CHAIRMAN: No, thank you very much, Professor Yarrow.

17 (The witness withdraw)

18 MR. SAINI: The next witness is our expert, Mr. Bolt.

19 Mr. CHRISTOPHER BOLT, Sworn

20 Examined by Mr. SAINI

21 Q Mr. Bolt, can you give your full name and your business address, please?

22 A My name is Christopher Bolt. My business address is now Cherry Tree Cottage, Blue
23 Anchor, Minehead.

24 Q Would you find core bundle 2, and turn to p.744. Perhaps you can just look at that
25 document which ends at p.758. Is that your first expert report?

26 A It is.

27 Q Can you also go slightly ahead to p.761, ending at 765. Is that your second report?

28 A It is.

29 Q Do you adopt those reports as your evidence?

30 A I do.

31 Q Thank you very much, please stay there.

32 Cross-examined by Mr. READ

33 Q I assume Miss Rose has no questions. That is right. Mr. Bolt, can I ask you, first of all, to
34 turn to p.757 in your report. Do you have that?

1 A I have.

2 Q If we look there, it is a list of materials relied upon in preparing this report?

3 A Yes.

4 Q Can I ask you to go back in your statement to p.751. Looking at p.751, footnote 13, you
5 refer to “The role of subsidy in privatisation”, by ME Beesley – do you see that?

6 A I do.

7 Q It is not in your list at 757, is it?

8 A The documents there were the ones I was given in preparing my report, which I used, and I
9 read all of those documents to identify issues to cover in my report. Where I have referred
10 to other sources they are in the footnotes, as you have identified, yes.

11 Q I thought that would probably be the case, and we see that at various other footnotes as well,
12 do we not?

13 A Yes.

14 Q Can I ask you to go slightly earlier in this core bundle to tab 25, and can I ask you to look at
15 para.159 in particular, which is on p.704 – do you have that?

16 A Yes.

17 Q It says in para.159 – this is Professor Yarrow and Dr. Decker’s report – you understand the
18 provenance of it?

19 A Yes.

20 Q It says:

21 “While we accept that regulators such as Ofcom need to apply the relevant
22 economic principles in specific factual contexts, and that this may involve the use
23 of practical and simplified tests and procedures which do not accord with the detail
24 of theory from which they may have been first derived, there is an obvious need to
25 ensure that such simplification does not deviate from the underlying principles and
26 purposes of the testing in too great or too substantive a way.”

27 You would not disagree with that, would you?

28 A I wouldn’t disagree with that. It’s a question of how it’s applied in practice.

29 Q If we go back to your first report, which is tab 28, we see at p.745 a section dealing with
30 “Ofcom’s approach to the use of DSAC in assessing whether charges are reasonable” – do
31 you see that?

32 A I see that.

33 Q That follows on from what you have said in para.1, where you say, “I have been asked to
34 address of whether Ofcom’s approach was reasonable” – yes?

1 A Yes.

2 Q If we look in that section A starting on p.745, we find no discussion there specifically about
3 how Ofcom have used the test?

4 A It looks at the question of the definition of the DSAC test, and its derivation from the theory
5 of, for example, contestable markets, and is addressing the point that you identified from
6 Professor Yarrow and Dr. Decker's report about whether DSAC met the tests in the senses
7 they set out that it was the closest you could get to a practical application of a theory.

8 Q I do not think anyone is disputing in this case that you can have practical applications of
9 tests. The key issue is how you use those tests and what you use those tests for, which is the
10 very point that, of course, Professor Yarrow was making in the paragraph I have just taken
11 you to. You understand that?

12 A I understand the point, yes.

13 Q What I am trying to get an understanding about is where in this report you actually lay out
14 what your understanding was of how Ofcom had used the test?

15 A What I tried to do in this report is to set out my understanding of how Ofwat [sic] developed
16 the test.

17 Q Sorry, Ofwat or Ofcom?

18 A I'm falling into the same problem as Professor Yarrow. There are too many regulators.
19 Ofcom defined the test and its relationship to economic theory, and I've set out other
20 examples of regulators in other sectors similarly looking at practical definitions of the test.
21 What I've not, and I've certainly not claimed to have done, is to look at the detail in the
22 numerical sense of how the test that has been applied in the way that Ofcom clearly set out
23 in detail in their determination to cover the sort of analysis which Professor Yarrow and Dr.
24 Decker have undertaken. I was not asked to do that and that is not something that I would
25 claim expertise on.

26 Q Surely, in order to actually understand how Ofcom have approached the use of the DSAC
27 test, you need to understand something about what exactly they have used the test for?

28 A I think it goes back to a previous stage in a sense. The starting point clearly is that there is a
29 cost orientation obligation that has been developed and placed on BT. In a sense, the issue
30 for discussion is not whether it was appropriate to have that cost orientation obligation, it is
31 whether the approach which Ofcom in using DSAC as the practical application of that test
32 was appropriate or not. The question I was asked was whether, in my view, it was
33 reasonable as an approximation to the economic theory, looking also at examples of
34 whether other regulators had adopted similar types of test as practical examples. I think the

1 point has come out already in evidence that although DSAC and DLRIC are not terms
2 which other regulators use – I think all regulators use slightly different terminology, and
3 indeed pronunciation as to whether LRIC or L-RICs, but everyone has to start with the very
4 simple but not very useful theory set out by William Baumol of stand alone costs and
5 avoidable cost floors, and work out how that can be applied in practice.

6 Q Mr. Bolt, that is the issue, is it not, how you apply the test in practice, because, as you have
7 already accepted from the paragraph in Professor Yarrow’s report, the core issue is whether
8 you have allowed a practical over-simplification to create unintended consequences – yes,
9 that is what you have agreed to?

10 A You clearly need to have a pragmatic implementation which achieves the regulatory
11 objectives.

12 Q How do you assess that if you have not actually assessed precisely how Ofcom has used the
13 test in this instance?

14 A I think the distinction is between the use of this sort of test as a first order and any
15 additional analysis which follows on from it. The DSAC test as a first order test seems to
16 be without needing to look at the detailed assessment of consequences in a particular case as
17 being a pragmatic implementation to strike the sort of balance which Professor Yarrow was
18 talking about in his report. What I’ve not been asked to do, and have not done, is to look at
19 whether the supplementary analysis beyond that has addressed other issues which may be
20 relevant in a particular case. If the question is, do I believe DSAC is an appropriate first
21 order test, the discussion in my report sets out why I concluded that it is.

22 Q Does it not come back to the question of what do you mean by a first order test?

23 A I think it is partly that, but there again, to be clear, I have no problem with the use of “first
24 order” in a sense of establishing a rebuttable presumption. It is much stronger than a mere
25 screening test, and my experience of regulation in a number of regulatory offices and in a
26 regulated company is that if you don’t have something which establishes a reasonable
27 presumption of that sort regulation is so uncertain in its application that it neither achieves
28 the objectives which regulators are looking to achieve, nor is it a practical basis for a
29 regulated company to operate on.

30 Q Can I ask you to look at a file called BT3, and just look at tab 12.1, and go to para.3.5. I do
31 not know whether you have seen this document before. Have you seen this document
32 before?

33 A I have seen it before, yes.

1 Q Just look at what it says in para.3.5, because we know it is dealing with the cost orientation
2 condition. It says:

3 “In the event of a complaint under Condition 13.3, that a charge is not reasonable,
4 or under Condition 13.4 to the effect that a charge is not reasonably derived from
5 forward looking incremental costs of the service, a first order test will be whether
6 the charge in question falls between its incremental cost floor and its stand-alone
7 cost ceiling. The primary focus of the investigation of a complaint under condition
8 13.3 or 13.4 will, however, be the effect or likely effect of the charge on
9 competition and on consumers.”

10 Is that what you understood first order to mean in this context?

11 A It is setting out a situation where there is a clear presumption of a problem existing, the
12 question then is what is the appropriate analysis to confirm that position and it will
13 potentially include a number of things, and I obviously see the words which Oftel back in
14 1997 used as describing what their primary focus would be.

15 Q Yes, but the point I am putting to you, Mr. Bolt, is that ultimately the relevance of a first
16 order test necessarily depends upon the second or other focus that you engage thereafter,
17 does it not?

18 A I don't think I would put it as strongly as that, nor do I think it necessarily follows that the
19 primary focus in any case would automatically be the sort of thing which is described here.
20 The example I have used in my first report of the approach taken by the Office of the Rail
21 Regulator to its freight charges, there was a more detailed investigation carried out in
22 certain cases, but all of that investigation was looking at costs and trying to get a more
23 precise assessment of the costs involved in a particular case, and it started from the
24 proposition that the charge control itself was set, the existence of what in telecoms terms is
25 called “the cost orientation obligation” reflected an assessment that there was a competition
26 issue which required to be addressed.

27 Q Would you accept this, looking at 3.5, that where it is talking about the primary focus of an
28 investigation of a complaint will however be the effect, or likely effect on the charge of
29 competition and non-consumers, that it is actually looking at an effects based analysis?

30 A That is clearly what that particular sentence envisages.

31 Q Could I ask you to go back to the core bundle in which your reports are actually there, and
32 can I ask you again to go to Professor Yarrow's statement, which is at tab 25, and go to
33 p.675,. You see he has a quotation there from Professor Hausman – you have heard of
34 Professor Hausman, have you?

1 A Before being involved in this particular case, no, but I have now.

2 Q Anyway, you cannot comment on Professor Yarrow's point that he is a foremost regulatory
3 economist?

4 A He is not a foremost regulatory economist generally, he may be in the telecoms world.

5 Q But he is saying: "Allocations such as fully allocated costs, equal allocation of cost and so
6 on are inherently arbitrary", and you would not disagree with that?

7 A I wouldn't disagree with that.

8 Q "Nevertheless, the results of such allocations have very important consequences
9 for regulated prices. These regulated prices in turn have important effects on
10 competition, economic efficiency and consumer welfare."
11 There he is suggesting that one of the core issues is the effects, yes?

12 A That is what he's suggesting.

13 Q Which chimes, does it not, with what you have just accepted from those guidelines that that
14 itself is indicating an effects based inquiry?

15 A The whole of regulation is predicated on the need to address issues arising from a lack of
16 competition, and normally regulators – and is certainly the case with Ofcom – have
17 statutory duties which look at matters such as consumer welfare, so yes, that is the basis of
18 how regulation operates.

19 Q Just going back to what the meaning of first order test is, would you agree with this
20 proposition, that a first order test can mean the ceiling for the service unless the regulated
21 company has exceptional reasons for departing from it. Would you agree with that?

22 A That is probably a reasonable assessment of what a first order test means in my view.

23 Q In other words, it is an almost conclusive test unless you can demonstrate exceptional
24 reasons for departing from it?

25 A The phrase I used earlier was "rebuttable presumption", it is rebuttable if there is evidence
26 why the test is inappropriate in a particular case for whatever reason, but it has to be pretty
27 clear evidence because the value of this sort of test comes from having a degree of
28 consistency and transparency and predictability in its application, and that is a benefit both
29 to regulation in its objective of trying to protect the interests of consumers, and to the
30 regulated company and having some certainty about how it operates.

31 Q You have mentioned transparency and consistency, that is a core point, is it not, with any
32 regulator, that any test that is crucial, it is crucial to know in advance precisely how that
33 testing is to be done. It is a core point, is it not, of regulatory ----

1 A The better regulation task force some years ago set out five principles of better regulation. I
2 think all regulators sign up to those – predictability, transparency, consistency are three of
3 them.

4 Q So unless you have made it clear in a document precisely how you intend to use the test, it
5 fails that consistency and transparency?

6 A But there is an obligation on both sides. If the company believes that there is insufficient
7 clarity, and I have been, again, in a position working for a regulated company with another
8 regulator, where we tried to get that clarity if we didn't think it existed. As I say, without
9 having gone back throughout the history of telecoms regulation, which I have not done, I
10 clearly cannot comment on whether between BT and Oftel (as it was originally back with
11 the 1997 Guidelines) that that standard of transparency was achieved or not.

12 Q But you would agree with this, that it would be wrong to apply effectively a regulatory
13 intervention years previously if there had been any ambiguity in the test that was being
14 applied?

15 A It would not be good regulation in my view to invent retrospectively tests which apply to
16 the past.

17 Q Yes, thank you. Now, can I take you again to Professor Yarrow's report at tab 25, para. 79?
18 Do you have it?

19 A I do.

20 Q He says:

21 "So far as we know, Ofcom is unique among telecoms regulators in adopting this
22 particular benchmark, and it is clear that there are typically a number of
23 alternatives to equi-proportionate allocations of fixed and common costs which
24 might, in general, be deemed to satisfy the 'appropriateness' criterion of the cost
25 orientation obligation."

26 Do you agree as a general point that as far as you have been able to ascertain no one uses a
27 test that is described as "DSAC" and "DLRIC"?

28 A So far as I am aware no one else uses those terms. Other regulators use ----

29 Q Just pause, let me finish the question. As far as you are concerned, Mr. Bolt, does anyone
30 use the precise test that Ofcom have deployed in this case, namely distributing fixed costs to
31 particular components?

32 A As far as I am aware no one uses it in precisely the way Ofcom does. Other regulators use
33 tests which are, in my view, so close to the DSAC test as to be indistinguishable.

1 Q I want to explore those tests with you because you have given effectively, I think, two
2 examples, have you not – one in the rail freight industry and the other with the Post Office,
3 yes? Those are the two examples you have given?

4 A And I have referred also to the experience in the gas sector.

5 Q Yes. I want to look at the material that you actually produced in that. Can I, in fact, take
6 you straight away, I think, to the material that you have actually supplied in your report, and
7 this is in DF5. Can I ask you to go to tab 4 first of all? This is the Track Access Charges
8 for Freight Services. This is one of the instances you say where there has been an
9 analogous test used?

10 A Yes.

11 Q Did you actually devise this test, by the way?

12 A I did.

13 Q Can I ask you to then go to tab 5 and see the context in which this test was actually
14 produced. This is a document that you rely on from Mr. or perhaps Professor Beesley – is
15 he Mr. or Professor?

16 A The late Professor Beesley, yes.

17 Q Professor Beesley – dealing with the position in the rail privatisation, because this was a test
18 that effectively came out of the rail privatisation process, did it not?

19 A Yes.

20 Q If we go to p.243, we can see that in fact in 1995/1996, I am looking here at p.242 of the
21 document: “... explicit passenger grants accounted for £1.7 billion?”

22 A Yes.

23 Q This test was devised very much from the point of view of it being privatised, something
24 that was necessary to resolve pricing, and there was a £1.7 billion of government subsidy
25 going into it?

26 A But the situation we are talking about is freight charges, the £1.7 billion you are quoting is
27 all passenger services.

28 Q Yes, okay. That was the subsidy for the passenger, but it is also fair to say that one of the
29 key issues with it was that in fact the rail freight segment of it was being floated?

30 A The rail freight companies were sold off to the private sector, yes, without any inherent
31 subsidy and that is why I consider this is an analogous example, because there was a desire
32 to develop competition in the rail freight market.

33 Q I see, okay. Well let us go back to the document you rely upon then, which is at tab 4, and
34 if we can go to p.14. At 2.10 we see the conclusion – this is freight, so there is no dispute

1 that we are talking about freight here – we see there that the Regulator concludes four
2 different factors, does he not? The first is that:

3 “(a) charges should be greater than or equal to the avoidable cost incurred by
4 Railtrack as a direct result of carrying that particular freight flow”?

5 A Yes.

6 Q Then secondly:

7 “(b) charges should be less than or equal to the standalone cost which would be
8 incurred by a notional efficient competitor.”

9 Just so that we are clear there, we are not talking about any distributed standalone costs we
10 are talking about true standalone costs as in contestable market theory?

11 A That is the basis of that particular point, yes.

12 Q So what he is doing there is, he is saying very clearly, standalone costs should be the charge
13 effectively by which charges are benchmarked?

14 A The Regulator was setting out – he says “no more and no less” than the position, for
15 example, taken by Baumol in the document that I also refer to, the simple standalone
16 costs —

17 Q Absolutely right. But he was taking as his benchmark for assessing whether or not
18 ultimately the charges were properly cost orientated. He was taking as his benchmark
19 standalone costs.

20 A Not as the benchmark, no. This is saying that those criteria in their totality were applied.
21 The first two in a sense provide the basis in economic theory. The other criteria are, this is
22 modifying that in the particular context of the rail freight sector, given the objective as
23 I referred to earlier to develop competition in the freight market; and recognising, as is
24 done in later parts of the document, that standalone costs for individual freight flows, if you
25 are attributing all the common costs that single freight flow will produce a value for
26 standalone cost which is so high as to be meaningless and not useful as a Regulatory tool.

27 Q Mr. Bolt, I am just look at what this document actually says. If you go back to p.12, this is
28 a section dealing with the general framework, is it not?

29 A It is.

30 Q At p.13, at 2.8 it says that the “Criteria to be Applied”, yes?

31 A It does.

32 Q And in para.2.10 he sets out his conclusions and why he caveats it by saying:

33 “While every case will be judged on its merits, he should normally expect to apply
34 the following criteria in his assessment of freight track access charges”.

1 Yes?

2 A Yes.

3 Q So he is setting out his test there, is he not?

4 A He is setting out the test. And the next section describes how those tests are applied in
5 practice, which turns those very simple statements into more sophisticated practical -----

6 Q With respect, Mr. Bolt, what he is actually doing there, he is saying, “Look, this is going to
7 be the benchmark for the charges and my assessment of them”. What he then goes on to
8 consider is the depth he has to go into in investigating them subsequently. This is the
9 framework by which he gauges whether prices are right or wrong ultimately.

10 A Those are the headline criteria. They cannot be read in isolation of the next section which
11 talks about application criteria.

12 Q Well, let us go to para.3.16 then, shall we? It sets out there:
13 “A key protection against excessive charges is the criterion that access charges
14 should not exceed a standalone cost ceiling”.

15 So he is reiterating there the point that he was making earlier on, okay? You accept that.

16 A Yes.

17 Q Yes. He then goes on to say, in para.3.17, that:
18 “In cases where charges are more than 50 per cent of Railtrack’s initial estimate of
19 standalone costs”.

20 Yes? So, what he is anticipating is that Railtrack comes up with an initial estimate of
21 standalone costs, is he not?

22 A It used its accounting systems to produce what it actually referred to as a “reference charge”
23 which was analogous to a standalone cost but had many features which meant that it was
24 not directly, it was not a direct measure of standalone cost in the sense economists would
25 recognise it.

26 Q It was an imperfect assessment of standalone cost.

27 A It was a very imperfect assessment.

28 Q Yes. But it was still an assessment of standalone cost even though it was very imperfect.

29 A It was the measure Railtrack at the time proposed from its own accounts based on — very
30 ill-developed Regulatory accounts — should be used to apply the criterion of standalone
31 cost.

32 Q It then goes on, in 3.17:

1 “In cases where charges are more than 50 per cent of Railtrack’s initial estimate of
2 standalone cost, therefore, the Regulator will require Railtrack to carry out an
3 individual assessment of its proposed charges”.

4 So, the trigger of this more than 50 per cent of initial estimate of standalone costs, yes?

5 And that is a charge that is in excess by 50 per cent of that standalone cost estimate, is it
6 not?

7 A No. If the charge was more than half —

8 Q Sorry, you are absolutely right. It is a 50 per cent —

9 A Fifty per cent off Railtrack’s —

10 Q So, where charges are more than 50 per cent of the standalone cost:

11 “ ... therefore the Regulator will require Railtrack to carry out an individual
12 assessment of its proposed charges”.

13 Yes?

14 A Yes.

15 Q So, in other words, that 50 per cent test, as you rightly say, it is 50 per cent of the
16 maximum, triggers Railtrack in carrying out a further individual assessment of its proposed
17 charges, yes?

18 A Yes.

19 Q Does not lead to the Regulator there and then assuming that the charges are not cost
20 orientated.

21 A Not in this framework, no.

22 Q No, absolutely. And then he goes on to say;

23 “There are three principal ways in which he will expect this assessment of
24 standalone costs to differ from Railtrack current ‘reference charge’ calculation”.

25 And then he sets out:

26 (a) It should use specific data wherever possible,, rather than the single national
27 average ... ;

28 (b) It should relate to the costs of a notional efficient competitor, and should therefore
29 exclude costs which reflect inefficiency; and

30 (c) It should take account of the opportunities for the notional efficient competitor to
31 attract traffic from other existing freight flows”.

32 So that is an effects analysis, is it not?

33 A No, it’s a cost analysis, and I think we are in the same position in this document as came up
34 in evidence from Professor Yarrow yesterday of the phrase “standalone cost” being used by

1 Regulators in slightly different ways. What was envisaged under (c) there was that the
2 common cost should be distributed in an appropriate way across a bundle of freight flows,
3 not simply the one in question. So, it is clear if you take the phrase, the beginning of that
4 paragraph, you know, that he will expect “this assessment of standalone costs”, that what
5 the Regulator was proposing was a standalone cost which involved a degree of distribution
6 of common costs. That is what (c) means.

7 Q With respect, Mr. Bolt, how can anyone possibly ascertain that from that paragraph?

8 A I’m explaining to you what the author of those words meant, and what the Regulator at the
9 time thought they meant.

10 Q I am not really interested in what the author of the words actually intended. As lawyers
11 always tell you, people often intend different things in their documents, but they produce
12 different results. What I am asking you is where does that in anywhere in that paragraph
13 3.17 does it suggest that there has to be some form of distribution of charges going on?

14 A If you take what is in 3.17(c) with other references, for example, in 3.19, you know,
15 “The Regulator also considers that any assessment of standalone cost should make
16 some allowance for the ability to share facilities where several high value freight
17 flows are using the same route. The Regulator does not believe it would be
18 appropriate for Railtrack to be charge each of those flows at or near the standalone
19 cost of a dedicated facility”.

20 That is not using the word “distribution”, but it is very clear, I believe, from that paragraph
21 that that was what was envisaged.

22 Q What it is actually saying is it should make some allowance for the ability to share facilities.
23 It is not saying how it is going to be done or anything like that, is it?

24 A Not in this document. He was not. No.

25 Q No. Well, which document was he saying it in?

26 A This was a charging policy statement produced at the very beginning of the rail privatisation
27 process to set a framework for Railtrack, indeed at this stage before it was privatised and for
28 the newly privatised freight operating companies to start to get some practical experience of
29 how the track access charging regime worked.

30 Q And it was never actually in reality put into practice, was it?

31 A It was overtaken by several events, one of which at subsequent price reviews was a
32 government decision that the freight sector itself should be subsidised.

33 Q So this, in effect -----

34 A A move by the government away from competition.

1 Q This in effect was a preparatory test that never actually saw the light of day.

2 A It was applied, as I made clear in my witness statement, in one particular case it did not
3 develop into the sort of routine test that was originally envisaged when the framework was
4 put together.

5 Q Just so that we have, we can put this one particular test to bed, 3.17, which is the “half
6 SAC” if I can call it, test that you have said has some analogy to DSAC, nowhere at all —

7 A Sorry, I have not said that the half SAC test is analogous to DSAC. What I’ve tried to argue
8 is that the principle underpinning, sub-paragraph (c) in 3.17, envisages a form of
9 distribution of common costs which is in a sense the heart of DSAC, that common costs for
10 the purposes of a costs orientation test can be distributed across a bundle of products rather
11 than all being charged the same one in applying the standalone costs test.

12 Q We can beg to differ as to what 3.17, read in the light of 3.19, actually means. But I can put
13 this to you, can I not, that nowhere within there does it say that this further testing would be
14 a very significant test?

15 A Could you —

16 Q Yes. It does not actually say anywhere the primacy the Regulator is going to put on this
17 test.

18 A The situation, as I explained earlier, was one where Railtrack’s regulatory accounts were
19 not at all well developed. The 50 per cent of the reference charge was in that sense saying
20 “There is a problem”. The intention reflected elsewhere in this document was that the
21 initial application of criteria would be kept under review with the aim of developing
22 something which was much closer to a first order test in the way Ofcom have applied to
23 DSAC.

24 Q I see. So you think that para.3.17 is laying out a test that says, “If you exceed any of this
25 particular point, you can only do so if you can satisfy us there are exceptional reasons”.
26 You are saying that that is analogous to that sort of test.

27 A No, I am not saying that is analogous. What I am saying is that the calculation in 3.17(c)
28 envisages an approach to the definition of standalone costs which has broad similarities
29 with DSAC, but it envisages common costs being distributed across a bundle of products as
30 a workable regulatory test, and that the intention reflected elsewhere in this document was
31 in the light of experience to develop the 3.17(c) test into something which is much closer to
32 what Ofcom described as a first order test.

33 Q So you are saying in effect that this was all going to be developed in the future.

1 A But already in 3.17(c) has the concept, without using the words, but the concept of
2 spreading common costs across a bundle of products. As the practical implementation of
3 the words “standalone cost”.

4 Q I think ultimately it will be a matter for submission, but Mr. Bolt, I am going to put it to you
5 again, this is not in any shape or form analogous to the DSAC test as applied by Ofcom in
6 its final determination.

7 A I don’t accept that.

8 Q Can I ask you to move on to your second example, for which we actually have the
9 document provided, which is at tab.8 in bundle DF5. This is the Postcomm proposal, is it
10 not?

11 A It is.

12 Q Now we know, because I think we can see this, at para.S.33 on p.18 of the document,
13 I should make clear that when I am talking to 18 I am talking to the printed document on the
14 right hand, the printed number on the right hand side, because in fact this is a clipped
15 extract, is it not, from the actual report.

16 A It is the summary of the document. It has not been edited.

17 Q No, but, for example, I am not trying to trip you up in any way.

18 A But after the summary section it only includes section six.

19 Q Six, yes.

20 A Absolutely, yes.

21 Q So, what I am saying is, it is a truncated extract of the whole document.

22 A Yes, but the summary is complete.

23 Q Yes, and so we see in para.S.33:
24 “Postcomm is keen to deregulate wherever it can. However, the scope now for a
25 substantial deregulation is small owing to the limited development of competition,
26 with Royal Mail still retaining a 97 per cent market share”.

27 So it is a massive market share one was actually looking at in this situation, was it? Yes?
28 You agree with that?

29 A I agree with that.

30 Q The document also was plainly setting, not a cost orientation obligation, but in fact a price
31 cap, yes?

32 A Yes.

33 Q And we see that at p.24 at, for example, S51 and S52. In S52 we can see that it was a
34 classic charge control of RPI minus X, yes?

1 A Yes.

2 Q So, how precisely do you think this is so analogous if the purpose behind the testing is
3 looking at a charge control as such?

4 A Because it is looking at charges within a basket and clearly if you have a price control
5 framework with freedom to price within that basket, you need some regulatory criteria for
6 how that is done.

7 Q But, are you saying that the obligation under a cost orientation obligation is precisely the
8 same as an obligation under a price cap obligation?

9 A I am not saying —

10 Q No.

11 A -- it is precisely the same, because — but the principles that within a price cap if there is
12 freedom to price there should be criteria for doing that. There are strong similarities in
13 many cases between those criteria for freedom to price within a price cap and those which
14 might apply under a cost orientation obligation.

15 Q We also know that in fact the basis upon which the opening regulatory asset base was being
16 done was upon a valuation approach, and we see that from S.29 I think it is. Page 17, yes?
17 So it was quite a detailed analysis going on about how exactly one should actually measure
18 the asset base.

19 A Agreed.

20 Q Now, if we can go to, perhaps if we just look at para.S30, it is fair to say that there they are
21 very much looking at weighted average cost of capital, yes?

22 A Yes.

23 Q And if we go on to, for example, para.6.26 which I think is on p.42, they were considering
24 this very much in the context of fully allocated costs, yes?

25 A Yes.

26 Q And then we know from para.6.63 at p.53 that cost allocation was going to be developed
27 and changed in the future, and I think if we see that, it says, setting out the conclusions, it
28 says:

29 “* there should be separate tariff baskets for products serving captive and
30 non-captive customers ...;

31 * that costs should be attributed between baskets using Royal Mail’s approach
32 to costing except for pension deficit and profit allowance costs, which should be
33 equi-proportionately marked-up over other costs;

1 * Postcomm will aim to make a decision about any proposals from Royal Mail to
2 change its pricing structure ... within 9 months of receiving an application from
3 Royal Mail that is based on good quality information”.

4 So, again, it was very much a test, a process, in the stages of development, was it not?

5 A It was clearly in the context of developing competition in the postal sectors and against the
6 background of proposals from the Post Office which have since been approved to introduce
7 charging by size as well as weight, so that we now have large letters and packets with a
8 different charge than other smaller letters. The principle is still, I think, relevant that within
9 the overall price cap, because of the desire to promote competition in postal services, there
10 was quite a lot of attention being given to the costing of individual services and groups of
11 services and the appropriate regulatory principles for assessing that. And I take all the
12 points that Professor Yarrow was making yesterday about the economic basis of costing and
13 the arbitrariness that any particular measure involves. But if you are going to apply
14 regulation in practice, you have to make those approximations.

15 Q But, again, it is in the context of a price cap, is it not? There is no doubt at all —

16 A It is clearly in the context of a price cap

17 Q -- that it has been done in the context of a price cap.

18 A Absolutely right.

19 Q You see, again, I put the point to you yes, they are talking about allocating costs between
20 different baskets, although it is being said obviously in a completely different context,
21 where can you derive any support from this document for saying that a ceiling should not be
22 departed from, save in exceptional circumstances when you are looking at a costs
23 orientation obligation.

24 A The point I was trying to make on the basis of this material from Postcomm is that, even
25 within a price cap framework, if you have considerable freedom to vary the charges for
26 individual components, you need to develop tests for the variability which is acceptable in
27 regulatory terms and the test which Postcomm is reflecting in this document is accepting
28 that fully allocated costing for every product is not appropriate, that there should be some
29 freedom, and the approach that is being envisaged involves a distribution of common costs
30 and a development of ceilings and floors which is not dissimilar to the DSAC and DLRIC
31 approach.

32 Q Can I ask you to look at Professor Yarrow’s report again, at p.753. At para.30 he says this:

33 “The nature of the adaptation required is certainly different between industries, and
34 may even differ within the sector, depending on the matter under consideration or

1 the circumstances prevailing. In my experience, Regulators are aware that the
2 application of pragmatic approaches requires caution to avoid unintended
3 consequences”.

4 I am sorry, I said Professor Yarrow, it is actually your report.

5 A Yes.

6 Q That is the point I am making.

7 A I obviously agree with that.

8 Q Yes, you absolutely agree with it. I am very tempted to draw stumps at that point, but I will
9 carry on! That is not in any shape or form really different from what Professor Yarrow has
10 been saying is it not — that you have to avoid the unintended consequences. And that
11 requires you to assess the individual test in its context.

12 A I think we all agree that there can be unintended consequences. I think the difference is
13 how you avoid them, and I think I would differ from Professor Yarrow in saying that
14 practical regulation does not always require or indeed permit detailed case by case
15 assessment; that sometimes it is better regulation to have a clear framework where the
16 debate and analysis has gone into establishing the framework which is then applied in a
17 reasonably rigid way, the rebuttable presumption, but it is still a presumption. If you have
18 so much uncertainty that there is only a screening test and the outcome in each particular
19 case depends on the detailed analysis which is then done. That can often have worse
20 unintended consequences and undermine, for example, the relevant competition than a test
21 which has some rough edges but is applied with more certainty.

22 Q Well, we beg to differ on that point, but you agree with this, do you not, that test is
23 absolutely no use at all unless people actually know in advance that that is the test that is
24 going to be applied?

25 A We certainly agree that there needs to be transparency and consistency in the application of
26 the test.

27 Q Can I ask you one final point, it is at DF3, and can I ask you to go to tab.3. It is Professor
28 Baumol’s own document. Can I ask you to go to p.90 of that document. It is actually
29 talking about price caps, which is what we have been looking at. He is talking about price
30 caps here and then he goes on to talk about them in the context of baskets of services. And
31 he concludes it:

32 “The purpose of this provision is to increase still further the domain of price setting
33 freedom of the regulated firm, and to prevent the rules from having unexpectedly

1 severe consequences for any one narrowly defined service an occurrence that can
2 otherwise be expected to happen somewhere simply by happenstance”.

3 Yes? Now, you would agree, would you not, that the more granular the focus, the greater
4 the risk that you end up with some anomaly occurring by chance?

5 A I think that depends very much on the circumstances.

6 Q I see.

7 A I could not agree it as a general proposition.

8 Q Well as you said, you do not know about the particular circumstances of this case, so I am
9 not going to —

10 A Well, I give that answer based on my broader regulatory experience.

11 Q Yes, I understand that. Thank you, Mr. Bolt.

12 (Adjourned for a short time)

13 THE CHAIRMAN: Miss Rose?

14 MISS ROSE: Sir, I call Derek Ridyard.

15 Mr. DEREK JACK RIDYARD, Sworn

16 Examined by Miss ROSE

17 Q Mr. Ridyard, could you take bundle CB2. Could you turn to tab 30 in CB2, there is a
18 report, and you are Derek Jack Ridyard?

19 A Yes, that’s right.

20 Q And your business address is 198 High Holborn, London?

21 A Yes.

22 Q If we go to p.789, is that your signature?

23 A Yes, that is.

24 Q Does this represent your evidence?

25 A Indeed, it does, yes.

26 Q Would you just wait there please.

27 THE CHAIRMAN: Mr. Saini, any questions?

28 MR. SAINI: I have no questions, sir.

29 Cross-examined by Mr. READ

30 Q Mr. Ridyard, can I, first of all, ask you whether, at any stage in your report, you actually list
31 the materials that you relied upon for the purposes of composing your report?

32 A I haven’t listed them in one place, but I’ve referred to them as and when I’ve relied on them
33 in the reports.

34 Q Can I ask you to go to p.785 in your report, and at para.66 you say:

1 “As set out in the Determination trunk charges were originally excluded from the
2 formal charge control due to a belief that the provision of the trunk capacity was a
3 potentially competitive activity in which BT’s charges would be constrained by the
4 threat the Altnets would install their own trunk infrastructure.”

5 There you are talking about how trunk charges were originally excluded at the time of the
6 2004 market review process, are you not?

7 A Yes, I am.

8 Q You contrast that in para.68 with Ofcom’s subsequent decision to place the provision of
9 trunk segments into the charge control basket – yes?

10 A Yes, that’s right.

11 Q There, so we are clear about it, you are talking about not the 2004 process but the 2008/09
12 process?

13 A Yes, that’s right.

14 Q The suggestion that in 2004 trunk was not going to be competitive for the period covered by
15 the 2004 review is, in effect, wrong, is it not?

16 A My understanding is that in 2004 Ofcom certainly regarded BT as having significant market
17 power in the provision of trunk, but they didn’t go so far as to require it to be part of the
18 charge control mechanism. To me, as an economist rather than a lawyer, they put BT on
19 notice saying, “We think you have market power, we think there are potential problems in
20 this part of the market, but we don’t think those problems are so great at this stage to justify
21 putting them into the charge control basket”. I think it’s a graduation of levels of concern
22 on Ofcom’s part, and this was, I guess, fairly high up in that level of concern but not high
23 enough obviously to put them into the charge control.

24 Q It was going to be potentially constrained, was it not, by market activity, or it could be
25 potentially constrained by market activity?

26 A That must have been the judgment that Ofcom reached. I was here when Mr. Myers gave
27 his evidence on these points either on Friday or Monday, and I think he explained Ofcom’s
28 thinking on that very clearly. It was almost, it seemed to me, an experiment to see to what
29 extent competition in the competitive provision of trunk capacity would work, and, as it
30 turned out, as I think Mr. Myers explained pretty clearly, Ofcom decided that that hadn’t
31 worked and therefore it needed to be thrown into the proper charge control for the latest
32 period.

1 Q Can you look at Professor Yarrow's second report, which is at tab 26 in that bundle. Can I
2 ask you to look at p.734. You will see at para.71 he actually gives a quotation there from
3 the 2009 Leased Lines Charge Control – yes?

4 A Yes.

5 Q You will see he quotes para.4.22, and the bit at the bottom there:
6 "We also highlighted that trunk markets were prospectively more competitive than
7 TISBO."
8 Do you see that?

9 A "Prospectively more competitive", yes.

10 Q That is, in fact, a footnote. We looked at the original document earlier on. You are not in
11 any way disagreeing with what Ofcom have said there in the course of 2009 review?

12 A My understanding is that the terminating segments are completely uncompetitive. To say
13 that trunk is prospectively more competitive ----

14 Q Subject to that caveat ----

15 MISS ROSE: Sorry, can you let him finish.

16 A The point is that it is a relative term "prospectively more competitive" – "prospectively
17 more competitive" than something for which there is no prospect of competition pretty
18 much at all. Clearly, Ofcom's thinking was in 2009 the trunk charges should be in the
19 charge control. Therefore, they had at that point given up on competition as the solution
20 and resorted to regulation.

21 Q Vis-à-vis trunk?

22 A Yes.

23 Q Can I ask you a series of points about DSAC and see how much common agreement there is
24 between us. Firstly, do you accept that it is possible for a charge to be above the DSAC
25 ceiling but still be cost orientated?

26 A Yes.

27 Q Secondly, do you accept that you can pass all the DSAC ceiling tests – in other words, you
28 will be below the DSAC ceilings – and it is still possible you might be significantly over-
29 recovering fixed and common costs?

30 A Yes, if you – yes, absolutely, there's a very strong chance of that if you're close to the
31 DSAC on all of your prices. Again, as the numbers in Mr. Myers' statement show, you can
32 have a very, very high overall return over the piece.

33 Q Thirdly, do you accept that the methodology as to how you derive the DSAC ceiling is
34 entirely dependent on the way one allocates costs?

1 A It's strongly dependent on an allocation of costs, yes. The DSAC calculation, as I think we
2 all recognise, is partly looking at the costs attributable to the service itself and partly an
3 allocation of some of the common costs that that service or that product shares with certain
4 other services.

5 Q So we are clear about it, there is one specific combination, if you like, of costs that are used
6 in obtaining the DSAC figures?

7 A Which DSAC figures?

8 Q If, for example, you are looking at the PPC figures for the DSAC ceilings for those
9 component parts, those figures are derived from one combination of products taken
10 together, and from that you allocate the fixed costs in order to derive the DSAC ceilings?

11 A For any particular product, as I understand it, you look to see what costs the supply of that
12 product has in common with other products, and within that group of products you allocate
13 the common costs according to the sub-division rule.

14 Q That is the point, there is one single group you take initially to allocate the costs. You look
15 at that group and you allocate within that?

16 A Yes.

17 Q Fourthly, can you agree that the allocation can be arbitrary?

18 A This term "arbitrary", I would like to explore what that means. I certainly agree, and I think
19 it's absolutely clear, that there is no one single correct answer to how you allocate common
20 costs. It requires some sort of mechanistic decision rule in order to allocate common costs
21 across individual products. There is no single correct answer as to how you do that. So in
22 that sense it's arbitrary in the sense that someone, somewhere, has had to exercise some
23 judgment to devise that rule. Whether it's arbitrary, in the sense of being unpredictable or
24 capricious or a pejorative notion of arbitrary, I think depends on the facts of the case. In
25 this case, my understanding is that Ofcom described this concept, certainly from 1999
26 onwards, and BT knew about the concept, and therefore it wasn't arbitrary in the sense that
27 BT, I think must have known, or I think it was clear from the evidence which I saw from
28 Mr. Budd last week, BT did know that DSAC was in existence and was a decision rule that
29 Ofcom was going to be using as far back as that. So in that sense it's not unpredictable,
30 because it was signalled to BT that that would be the way that calculation would be done.

31 Q We will come back to that in a moment. Can you take core bundle 2, which is where your
32 expert report is, and can I ask you to go slightly further on in the bundle to tab 31, p.1006.
33 This is Ofcom talking about the economics of cost orientation, and at para.A11.6 they say
34 this:

1 “Because of the existence of significant common costs between BT’s activities, BT
2 will only recover costs overall if at least some of its charges are above LRIC.
3 However, there may be many different way of attributing these common costs to
4 different services, none of which may be uniquely correct or uniquely reasonable.”

5 A Yes.

6 Q You would not disagree with that statement, would you?

7 A No, that’s pretty much what I said in answer to your question a moment ago.

8 Q Can I ask you this: one of the problems is that the more granular you make the focus the
9 more problematic the allocation tends to become at those more granular levels?

10 A Yes, I think I would agree with that as a generalisation, yes.

11 Q Sixthly, would you agree that DSAC is a unique test to this particular sector?

12 A I’m really not the person to help the Tribunal on that question. I heard Mr. Myers say that
13 he hadn’t come across it elsewhere. I haven’t used it elsewhere or come across it elsewhere,
14 so I really think that others are better able to inform the Tribunal on that than me.

15 Q Can I ask you to go back to your expert’s report, which is at p.771 ----

16 A Sorry, which tab is it?

17 Q It is tab 30, I think, so it is the tab immediately before the one you have just been looking at.
18 Perhaps I should start at p.770, just to put this in context. Do you have that?

19 A Yes.

20 Q Here you are dealing with the problems associated with aggregation, as you say – yes?

21 A Yes.

22 Q You then come up with an example which takes place over pp.771 and 772.

23 A Yes.

24 Q It is fair to say that that is a very simplistic example, is it not?

25 A That’s how I describe it in my report, yes.

26 Q Certainly what you have not done with this table is give any consideration to how fixed and
27 common costs might interplay. Your costs are simply costs, they are not divided into
28 marginal costs or fixed and common costs?

29 A That is correct, yes. I was trying to illustrate a particular point here, which didn’t involve
30 getting into those complications, although I certainly accept those complications are
31 relevant for other questions.

32 Q What you are effectively saying, are you not, in this section is that, if you aggregate, the risk
33 is that BT can effectively get out of any efficiency improvements in the price capped

1 terminating segment because of the effect of aggregating the trunk which is not price
2 capped with the terminating?

3 A I am saying it can get out of the intended rigour of the price cap. I am not particularly
4 making the point about efficiency here, but I am saying that the price cap is a kind of
5 contract, or an agreement, as it were, between the Regulator and the regulated company and
6 in my view it is important that that price cap is obviously well-defined and I think there is a
7 danger if you aggregate items in and outside the price cap, and the regulated firm was
8 allowed to rebalance prices or get an advantage out of the price cap because of something
9 that happened inside the price cap, the effect of that could be to relax the intended effect or
10 constraining effect of the price cap on the regulated firm.

11 Q You do, specifically, in para. 24 on p.773, look at the whole question of efficiency targets,
12 do you not?

13 A I do, yes.

14 Q It is part of your judgment in this as to how efficiency improvements might operate in
15 respect of the relevant cap?

16 A True, in para. 24 I was making a point which was an extension from the original very
17 simplified example, and the point I was making there – and I should be clear I am not
18 making any observations whether BT is or is not efficient, because I have not covered that
19 in my work. I was simply making the point that one of the points of price cap regulation is
20 you set the price cap and then you say to the regulated firm, if you can do better than what
21 we think will happen to your costs over the next five years, then you get to keep the
22 proceeds at least until the end of that period and that is an incentive for efficiency. The
23 point I was trying to make in para. 24 was that if, over time, the regulated firm knew that if
24 it didn't meet an efficiency target, or they didn't do very well on efficiency, they could
25 come back to a body like this and say: "Actually, our profits turned out not to be very high
26 in the regulated segments so can we have some more money in this unregulated segment as
27 a compensation" that would undermine the intended effects of that efficiency property of
28 the price cap, that is the point of principle I was trying to make in these paragraphs.

29 Q You accept because your example does not actually include it, that you have not looked in
30 any great depth how the fixed and common costs are actually playing out in this particular
31 instance, have you?

32 A It is not relevant to the example I am giving here because this is a very, very simplified
33 example of one particular point.

1 Q Can I take you to the final determination, which again is the next tab on in that bundle you
2 have, which is tab 31. Can I ask you to go to p.856? The items marked in yellow are all
3 confidential so if you can avoid specifically referring to anything within those borders?
4 A Understood.
5 Q If you look at table 5.2, that gives you an indication about various benchmarks. If you look
6 in 5.66 it indicates that: "... data presented in table 5.2 demonstrates the scale of common
7 costs shared by 2Mbit/s trunk", and then the figures are set out, and then it gives what BT
8 estimates common costs constitute, and you can see it is a very large figure, can you not?
9 A Sorry, let me just read this.
10 Q Yes.
11 A (After a pause) Yes, indeed.
12 Q We actually know that in the period in question BT's efficiency improved significantly. Do
13 you want to see the figures on that at all?
14 A Not unless you particularly want me to.
15 Q You accept it as a proposition, that is the point?
16 A Yes.
17 Q That efficiency could only have been the result of driving down fixed and common costs
18 given the sort of scale of common costs we are actually talking about here?
19 A I am not sure that necessarily follows, does it? Maybe you will have to take me to the
20 figures.
21 Q Okay, well perhaps I am not putting the question correctly. Let me put ----
22 A I think the question is clear, but I think the answer is "no", because these figures are
23 showing that a large proportion of the stand alone costs of one or two particular products – a
24 lot of that is common cost, but I don't know where the efficiency gains that BT achieved
25 came from. I don't know whether they came from common costs or things that were
26 specific to individual products.
27 Q Let me try and put the question in another way. The point is that if you are looking at
28 whether BT has been effectively able to manipulate the figures between the price capped
29 sector and the terminating sector, it is going to be very difficult for it to do it, if the costs are
30 common costs, is it not? It can do it if they are the marginal costs, but if they are the
31 common costs, fixed costs it is going to be very difficult to target only one element and not
32 another?
33 A It would depend what they are common between.
34 Q But at least in principle you accept that as a proposition?

1 A If the costs are common as between things in and outside of the price cap then I guess that
2 must be true.

3 Q Thank you.

4 A The costs within the price cap the phenomenon which I identified in para. 24 of my report I
5 think is still a valid phenomenon to worry about if you are interested in the dynamic
6 incentives of price cap regulation.

7 Q Can I ask you now to go back again to your report in the earlier tab, at tab 30, and to go to
8 para. 44. One of the things that is driving your understanding about that is the charge
9 control charges are generally set between distributed long run incremental cost, and
10 distributed long run ----

11 A I'm afraid there is a mistake there, that should be "and distributed stand alone costs" ----

12 Q I was just about to comment on that. Yes, taking that as read, the core point though that you
13 are saying there, the starting point must necessarily be that the charge controls are set
14 between DLRIC and DSAC?

15 A Generally, that is my understanding of where the charge controls start.

16 Q Would you take core bundle 1, and go to tab 6 and p.117 and these are the tables that
17 neatly summarise the Regulatory Financial Statements without us actually having to go
18 back and look at them. You can see that p.117 has for the year end 31st March 2003, and
19 for the year end 31st March 2004 over the page at p.118, do you see?

20 A Yes.

21 Q I think you were probably in court when this got referred to previously?

22 A Yes.

23 Q You will know that red means below DLRIC, blue means above DSAC?

24 A Yes.

25 Q We know also, do we not – say if you do not accept this as a proposition – we know also
26 that the prices were not adjusted in the 2004 price cap?

27 A I am sorry, what do you mean by that?

28 Q In other words, there is no question of the price cap when it was set in 2004 that the prices
29 in any way being for terminating segments being altered by Ofcom, they used the existing
30 prices?

31 A I'm not aware of it but I'm happy to take your word on that.

32 Q We looked at this document earlier on today but perhaps for the sake of completeness, if I
33 can find it, if you can take the bundle ADB2. Do you have that?

34 A Yes, I have, yes.

1 Q And there is a tab which should be tab 4 at the back?

2 A Yes.

3 Q And we see that that is the September 2004 statement which set the price charges, do you
4 see that?

5 A Yes.

6 Q And then if we go to annex C, which starts on p.100, but the page I would like you to have a
7 look at is p.106?

8 A Yes.

9 Q You see at paragraphs C.33:

10 "Ofcom therefore has decided to use current charges as the starting charges for the
11 PPC charge control ..."

12 A Yes, I see that.

13 Q So in other words, when Ofcom set the charge control it knew that for the year end 31st
14 March 2003, and 31st March 2004, there were numerous prices that were actually outside
15 the DLRIC, DSAC range?

16 A According to these particular BT Regulatory Accounts, yes. I know that Ofcom often
17 queries what is or is not in the BT Regulatory Accounts, so I don't know whether Ofcom
18 took a different view as to what the true numbers were, but certainly if we take these
19 numbers as given then what you say applies. I don't know what Ofcom believed or knew
20 about them at the time.

21 Q I understand what you are saying but on the principle that those are the figures you agree
22 that in fact your assumption in para.44 is not correct in this instance if those figures are
23 correct - yes?

24 A I think I say generally, and I think the statement of general principle there I believe is
25 correct. My understanding is that is the general orientation of charge controls, that Ofcom
26 is keen to ensure that they are not in excess of DSAC but in general that they are above
27 LRIC.

28 Q You say in para. 45: "I would accept that in non-regulated sectors DSAC is not a uniquely
29 defined price ceiling to which dominant firms need to adhere in order to avoid being found
30 to have used their dominant position."

31 A Yes.

32 Q I think you accepted earlier on that in fact it is possible in situations where DSAC has not
33 been exceeded that there may still be a breach of cost orientation or an abuse of a dominant
34 position?

1 A I think the point I am making is that, as I understand it, they are two different legal tests.
2 The cost orientation test, as I understand it, is a test which is applied to a regulated firm
3 already been put on notice as having significant market power, therefore the specialist
4 regulator is telling them “We’re watching those prices because we are concerned about your
5 ability to raise price above competitive levels”, and that is quite a different situation than a
6 firm which makes widgets or something in the rest of the economy which still, in principle,
7 could be found guilty of excess pricing but through the Chapter II provisions of the
8 Competition Act or the European equivalent. I think I am drawing a distinction there
9 between there is more of a hands-on regulatory role that Ofcom has in respect of BT in
10 respect of these SMP areas than would be the case if we were here talking about widget
11 company that just happened to have high market share and was accused of excessive prices
12 through the Competition Act.

13 Q Okay. You go on then to say that it is a rule that has been applied by Ofcom as their first
14 order check, and you said earlier on about the 1999 Guidelines, I think you mean the 1997
15 Guidelines, did you not?

16 A I don’t think I mentioned any guidelines, I said my understanding was that since at least
17 1999 BT was well aware of the existence of the ceiling because that was just my
18 recollection of the evidence that Mr. Budd gave in the Tribunal last week.

19 Q I think 1999 is a new date that has not actually come into focus before and I do not know
20 whether it will ----?

21 A Can we check the transcript on that as to what he said, but that was my understanding of
22 what Mr. Budd said and I was simply relying on that piece of evidence.

23 Q Okay, can I ask you then to take bundle BT3?

24 A Yes.

25 Q These are 1997 Guidelines, that is simply why I was asking about 1999, whether it was your
26 recollection that was at fault or whether you were talking about something else. This is at
27 tab 12.1, do you have it?

28 A Yes.

29 Q This is at para.3.5. Condition 13.4 is effectively a cost orientation obligation, and if we pick
30 it up after the second sentence.

31 “In the event of a complaint under Condition 13.3 that a charge is not reasonable,
32 or under Condition 13.4 to the effect that a charge is not reasonably derived from
33 the forward looking incremental costs of the service, a first order test will be
34 whether the charge in question falls between its incremental cost floor and stand-

1 alone cost ceiling. The primary focus of investigation of a complaint under
2 Condition 13.3 or 13.4 will however be the effect or likely effect of the charge on
3 competition and consumers.”

4 Do you see that?

5 A I see that, yes.

6 Q It is saying in terms there, the primary focus of the investigation will be effectively an
7 effects based analysis?

8 MISS ROSE: Sir, I do not really see how this witness can give assistance to the Tribunal on the
9 proper interpretation of this document.

10 THE CHAIRMAN: The wording is really for us, but carry on, Mr. Read.

11 MR. READ: I understand the point being made, but I just want to see whether this witness
12 accepts if that is right. Let me ask you to go back to core bundle 2, and could I ask you to
13 look at Professor Yarrow’s report, which is in tab 25, and ask you to go to para.45?

14 A Yes.

15 Q In para. 45 he is referring in particular to the European Regulators Group making the point
16 that “there is necessarily a degree of arbitrariness in their allocation amongst the different
17 services served by the common infrastructure.” Yes? “Similarly, in the appendix to the
18 Determination which discusses cost orientation, Ofcom states at A11.6 ...” and that is the
19 bit we have just looked at. He then goes on to talk about this arbitrariness, and then he
20 quotes a passage from Professor Hausman – have you heard of Professor Hausman?

21 A Yes, I have.

22 Q He is, as Professor Yarrow described, a really first rate economist?

23 A He’s a very clever chap, yes.

24 Q In fact, I think he has won a medal has he not for his pure brilliance?

25 A I’ve heard him describe those medals at great length, yes.

26 Q This is his statement here that:
27 “Allocations such as fully allocated cost, equal allocation of cost and so on are
28 inherently arbitrary. Nevertheless, the results of such allocations have very
29 important consequences for regulated prices. These regulated prices in turn have
30 important effects on competition, economic efficiency and consumer welfare.”
31 So there he is talking in terms of effects, is he not, and the importance of looking at the
32 effects?

33 A Let me just read this and see whether I agree or disagree with that.

34 Q Certainly, yes.

1 A (After a pause): He is saying that the decision that is taken by the Regulator has important
2 effects on competition and efficiency and welfare which I would agree with, yes, and what
3 he is saying here is it matters what decision the Regulator takes on these questions because
4 coming out with one number rather than another matters for the consumers who are buying
5 their services.

6 Q I did not mean obviously to ask you about the guidelines, but what I am putting to you, Mr.
7 Ridyard, is when you are analysing prices it is important to have in mind the effects they are
8 actually generating, and you would not disagree with that, I do not think?

9 A I don't disagree with that, that's why we're interested in price and cost orientation in the
10 first place, because price provides signals for consumers, whether they are businesses or
11 end consumers to make consumption decisions and that determines actual decisions in the
12 real world, but it is why all of this matters.

13 Q I hope that I can cut my cross-examination of you down considerably by asking you this: a
14 considerable amount of your assessment of economic harm is based on the statement of Mr.
15 Harding?

16 A I certainly rely on Mr. Harding's statement for evidence of manifestations of the phenomena
17 that I predict in principle in my report. In my report I am really dealing in principle with
18 what I think a distortion of competition would look like and then in a number of important
19 respects, because I do not know how these products in practice are put together by the
20 business people involved, I then rely on Mr. Harding's statement for confirmation or
21 rejection of those notions because he describes what, in this case, Cable and Wireless
22 actually does in the market place.

23 Q What you are really saying is to actually look at the concrete actual practical effects you
24 have relied on Mr. Harding's evidence, because you just do not have the concrete practical
25 experience in the telecommunications market?

26 A Yes, well I have relied on that as confirmation of the effects that you would expect, but I
27 think as an economist without knowing how to put a private circuit together I do know that
28 what are the things one needs to look at and a kind of framework for how you go about
29 assessing the effects of one set of prices versus another. So I think that is quite an important
30 part of the overall jigsaw puzzle, but theory without measurement is not particularly useful
31 to this Tribunal or anyone else, and therefore I think you have to put the two bits together.
32 Both are important in my view.

33 Q Let us look at where you deal with overcharge and economic harm, because you start at
34 p.785 in your report, CB2. The first section is dealing with context, and we had already

1 obviously touched on that. The next section is BT's inference from the absence of entry
2 into trunk and I think the battle lines are clearly drawn on that, and then you go on to deal
3 with at 4.3: "The possibility of distortion of competition from trunk price overcharge"?

4 A Yes.

5 Q And the first paragraph:

6 "The scope for supra-competitive trunk segment prices to distort competition is highlighted
7 in the First Witness Statement of Nick Harding"?

8 A Yes.

9 Q So you are heavily relying on Mr. Harding's statement in this section, are you not?

10 A My previous answer applies because the next paragraph says: "From standard economic
11 theory" and then I explain the theoretical framework with which you then look to see where
12 distortion might occur, so I've relied on the economic principles for the framework and then
13 I've looked to the evidence of the business person who actually competes in this market
14 for ----

15 Q Confirmation?

16 A -- whether the effect that I've predicted in principle seems to map out in practice.

17 Q So that is what you are doing in 73, you say. Then in 74: "In practice", here you are talking
18 about looking for the practical effects that you have been talking about earlier and that is
19 where you rely upon Mr. Harding's statement?

20 A Well the use of the words "in practice" there is perhaps not going to that point because what
21 I am saying there is, when I say "In practice" what I go on to say is these are the areas
22 where I would expect these effects to be observed if they were real.

23 Q For example, in para. 78 you give one of these effects, do you not? At the end of para. 78
24 on p.787, you say:

25 "Further, the First Witness Statement of Nick Harding suggests that BT's
26 downstream retail arm m Albion Yard have the ability to aggregate together
27 multiple 2Mbit/s services and substitute 155Mbit/s trunk for 2Mbit/s trunk thereby
28 circumventing the overcharge on 2Mbit/s."

29 A That's right, and I make it clear that my comment here is dependent on the assumption that
30 what Mr. Harding said was correct and we heard from his evidence that he now accepts that
31 is not a factor.

32 Q So whenever you are dealing with the actual practical effects, the end result, if you like, you
33 are dependent upon Mr. Harding's statement?

1 A I am dependent on the facts, yes, and in that case, the facts as I think have been clearly
2 brought out to the Tribunal are not the way that Mr. Harding understood them to be in his
3 statement, and therefore the links to my statement are very clearly set out.

4 MR. READ: Yes, thank you, Mr. Ridyard.

5 MISS ROSE: I have no re-examination.

6 (The witness withdrew)

7 THE CHAIRMAN: In that case we will adjourn until 10.00 on Thursday morning. I just want to
8 make one thing clear, I do not know whether you want to prepare written submissions or
9 not.

10 MR. READ: We are intending to.

11 THE CHAIRMAN: We are in your hands as far as that is concerned. If you think that will be
12 helpful to aid your oral submissions then that is fine, but we are not expecting it necessarily,
13 it is what will help you best to articulate your case in closing to us. 10 o'clock Thursday.

14 (Adjourned until 10.00 am on Thursday, 28th October 2010)

15
16
17
18
19
20