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IN THE COMPETITION
APPEAL TRIBUNAL

Case Nos. 1151/3/3/10
1168/3/3/10
1169/3/3/10

Victoria House,
Bloomsbury Place,
London WC1A 2EB

15 April 2011

Before:

MARCUS SMITH QC
(Chairman)

PETER CLAYTON
PROFESSOR PAUL STONEMAN

Sitting as a Tribunal in England and Wales

BETWEEN:

BRITISH TELECOMMUNICATIONS PLC
EVERYTHING EVERYWHERE LIMITED

Appellants

– v –

OFFICE OF COMMUNICATIONS

Respondent

EVERYTHING EVERYWHERE LIMITED
VODAFONE LIMITED
TELEFONICA O2 UK LIMITED
HUTCHISON 3G UK LIMITED

Interveners (Case 1151)

BRITISH TELECOMMUNICATIONS PLC
EVERYTHING EVERYWHERE LIMITED
VODAFONE LIMITED
TELEFONICA O2 UK LIMITED
HUTCHISON 3G UK LIMITED
OPAL TELECOM LTD
CABLE & WIRELESS UK

Interveners
(Cases 1168 and 1169)

HEARING DAY NINE

APPEARANCES

Mr. Graham Read QC, Miss Sarah Lee and Mr. Richard Eshwege (instructed by BT Legal) appeared for the Appellant.

Miss Kassie Smith and Mr. Philip Woolfe (instructed by Regulatory Counsel, Everything Everywhere Limited) appeared for Everything Everywhere Limited

Mr. Javan Herberg QC and Mr. Mark Vinall (instructed by the Office of Communications) appeared for the Respondent.

Mr. Tim Ward QC (instructed by Herbert Smith LLP) appeared for the Intervener Vodafone Limited.

Mr. Robert O'Donoghue (instructed by Telefónica O2 Limited) appeared for the Intervener Telefónica O2 Limited.

The Intervener Cable & Wireless UK was represented by internal counsel.

The Intervener Hutchison 3G UK Limited was represented by internal counsel.

The Opal Telecom Ltd did not attend and was not represented.

1 MR. HERBERG: Sir, in some way I have been pushed forward to give an interim response to the
2 Tribunal's proposals of yesterday evening, we thought it might be worth grasping that
3 nettle at the outset although it does not necessarily have to be determined immediately.
4 There is, especially for this case, an unusual measure of agreement between the parties,
5 accepting, I think, some of the thrust of what the Tribunal was proposing, but suggesting
6 some variations. In principle, everyone is content with the time allocations that were being
7 proposed by the Tribunal, we can allow for the law of diminishing returns on advocacy.
8 There is quite general lack of enthusiasm for, as it were, short interim closings followed by
9 written submissions subsequently for a number of reasons, partly because of the danger of
10 spill-over into further reply submissions which would almost have to follow once there was
11 one round, partly as it were from a collective desire to really grasp the issues and, indeed,
12 particular Tribunals now with our minds being focused with particular questions from the
13 Tribunal straight away to the extent that is possible, and also because quite a number of us
14 have some difficulties immediately after Easter that would mean that any deadline for
15 written submissions we think would have to be off until the middle of May even then
16 allowing for further replies, which would put off some way from where we are now. So we
17 are all, I think, collectively anxious unless it is necessary, to avoid that outcome and it
18 clearly may be necessary if there are particular questions either from this list or otherwise
19 that are not properly addressed in closing or that the Tribunal wants further consideration of
20 for whatever reason but then there could be a much more narrow opportunity for written
21 submissions on particular issues rather than general, if necessary.
22 What the parties would all seek would be for the closings to be on Tuesday and Wednesday
23 rather than Monday and Tuesday because there is an awful lot for us all to assimilate and
24 get ourselves into gear ready to go on Monday, and particularly for those who would be
25 starting off on Monday morning to assimilate answers to all these questions as well as to get
26 one's case in order is quite a tall order, even on the basis that the weekend is purely at one's
27 disposal. So what we would all like is if we could not sit on Monday and then do closings
28 on Tuesday and Wednesday.
29 In relation to the order of closing, the Tribunal indicated that it did not mind, I put in a plea
30 to the other parties to close late because I have specific concerns that I have advanced cases
31 in my opening and I have not yet had any response from, for example, Mr. O'Donoghue on
32 his argument, there has been no response at all and there have been also effectively cases I
33 developed in relation to EE and the burden of proof, BT, that have not been responded to. It
34 is not that I wanted the last word but I am very anxious that I, as it were, hear what is said

1 before I answer. On the other hand I, of course, recognise that I am not really entitled to the
2 last word, so what I think everyone is content with is that BT and EE would close first, and
3 then the Interveners, and then Ofcom, but allowing BT and EE a right of reply which could
4 come of their time, or we can adjust the time between us. In principle everyone would be
5 content, as it were, with that order, but there is a strong plea for Tuesday and Wednesday.

6 THE CHAIRMAN: Speaking for ourselves, and we will not make any ruling now, we quite take
7 on board the burden on the parties and I think I will not be speaking out of turn if I give an
8 indication that we will be likely to accede to that request for a start on Tuesday because we
9 do understand that it takes time, as it were, to pull thoughts together so they can be
10 expressed concisely and clearly rather than a stream of consciousness ----

11 MR. HERBERG: Indeed, and of course the parties will try and focus on the questions asked, and
12 no doubt will provide speaking notes insofar as it is felt appropriate written materials to
13 assist and or even to supplement so that not everything has to be gone through, so one
14 delays it to Tuesday or Wednesday that gives us the opportunity again to put something
15 helpful in writing.

16 THE CHAIRMAN: Absolutely. I think we are broadly content, we will talk about it amongst
17 ourselves but I anticipate that we will accede to those requests. There are just two short
18 points from ourselves. First, we have handed down a list of points that have troubled us, but
19 of course you may very well have views as to points that you think should trouble the
20 Tribunal which we have not listed there and of course, you will identify those for us as well.
21 Secondly, in your timings you probably had better take account of the fact that we are going
22 to regard this very much as an opportunity for discussion so that points that are troubling us
23 can be debated, and so clearly on some points I suspect there will be a fair bit of
24 intervention from us.

25 MR. HERBERG: Sir, yes, we will have to do quite careful dividing up among ourselves, because
26 there simply will not be time to deal with every party to deal with every issue.

27 THE CHAIRMAN: Exactly, well the messenger has not been shot, Mr. Herberg. We have taken
28 on board what you say and we will get back to you.

29 MR. HERBERG: I am very grateful.

30 THE CHAIRMAN: Mr. Read?

31 MR. READ: Yes, I was cross-examining Dr. Walker.

1 Dr. MICHAEL WALKER, Sworn

2 Cross-examined by Mr. READ

3 Q Good morning, Dr. Walker. I am sorry we were slightly at cross purposes yesterday
4 afternoon. Just so that we are clear what I am talking about, I am talking about market
5 related externalities, so if I use the phrase “externality” in the course of cross-examining
6 you, you understand that what I am talking about is something we say is related to a market
7 failure rather than an effect the other way, as I think you were explaining the use of your
8 word ‘negative externality’ in respect of the MTPE. Okay?

9 A Yes.

10 Q Can I ask you to go to para.64 of your first report, which is at C2, tab 45, p.18. You make
11 the point there that Ofcom appears to play down the MTPE and says that it should be given
12 less weight than the direct effect. Then you say: “It is not clear to me what the welfare basis
13 for this statement is. I understand that obviously this expert’s report is in the context of the
14 08 determination. If we go back to p.1 of your report, para.4, we see that you, in fact, by
15 this stage had read the draft determination, the supplementary consultation and the final
16 determination in the 0845/0870 dispute. Do you see that?

17 A Yes.

18 Q I think it is also fair to say that if one goes on to the next tab in the bundle, tab 46, which is
19 your second expert report, which is in January of this year, and if we go to para.8 on p.3,
20 you are specifically looking at the 0845/0870 determination, you say in terms:

21 “I wish to state upfront that I consider that my analysis contained in Walker 1 is
22 not affected by Dobbs 6, Maldoom 5 or any of the other new materials which I
23 have been instructed to review in [this context].”

24 You note that that includes Ofcom’s defence to BT’s 0845 notice of appeal which we see,
25 for example, in para.6, bullet point 4 above – yes?

26 A Yes.

27 Q If we go back to your statement in para.64 of your first report, C2, tab 45, p.18, are you
28 really suggesting that it is not clear to you what the welfare basis is for Ofcom to have given
29 greater effect to the direct effect?

30 A What I’m saying, and I think it’s clear, is that I see no reason why the consumer harm as a
31 result of the MTPE should be considered any less, should be weighted any less, than
32 consumer harm caused by other issues. I’m not saying that all the analysis that BT,
33 Maldoom, did and that Ofcom has done on 08X calls and the analysis of the externality, I’m
34 not saying I don’t believe they’re there, I am not saying that they are outweighed by the

1 MTPE. What I'm saying is that the effect on consumers should be weighted equally.
2 That's why I say it should be given less weight than the direct effect. The direct effect may
3 be greater, but in terms of actually how you weight consumer harm it should be weighted
4 equally.

5 Q Can I ask you to go to the 0845 final determination which is in bundle B1, tab 1, p.96,
6 para.7.85. Do you have that?

7 A I do.

8 Q As you can see there they set out the policy preference, and then they go on ----

9 A Sorry, do you mind if I just read this paragraph?

10 Q Yes, please do.

11 A (After a pause) Thank you.

12 Q You see there that Ofcom are setting out in terms that they consider that the OCP may not
13 have an incentive to fully take into account the negative effect on SP, since they are
14 customers of the TCP, not the OCP, i.e. that there is, and I think we should read there,
15 market related externality between the OCPs and SPs. This is a source of market failure,
16 and then it goes on to say that that is the reason why the greater weight that they assign to
17 the direct effect takes account act of the desirability of this market failure being
18 ameliorated. So they are setting out very clearly there, are they not, precisely why they give
19 greater weight to the direct effect?

20 A No, what they're saying, they're explaining why they think the direct effect is a significant
21 issue. I don't think they're saying – and if they are saying, I would disagree with it – I don't
22 think they're saying that consumer harm of a particular quantum caused by the externality
23 should be considered to be a worse effect, a worse level of consumer harm, than the same
24 consumer harm caused by a different effect. If they are saying that then I don't understand
25 why they would say that and I disagree with them.

26 Q You are being fairly clear on that, but can I ask you then to take another bundle, and I am
27 sorry to have to keep moving you around the bundles, CAT bundle 13, and can you go to
28 tab 3.1. This, in fact, is an exhibit to Mr. Myers' statement, and it adduces the Simplifying
29 Non-Geographic Numbers. We know that this is a document that you will have had at the
30 time Ofcom served its defence in the 0845 dispute and at the time you wrote your second
31 report when you indicated that you did not think the principles had changed between your
32 first report and your second report. Can I ask you then to look at para.A2.189, which I think
33 is on p.117 with the Simplifying Non-Geographic Numbers. Can I ask you, first of all, to
34 read to para.A2.189 to yourself?

1 A (After a pause) Yes.

2 Q It is quite clear what Ofcom are saying there, is it not, that effectively, because of this
3 market failure that they talk about, and they talk about it in quite some detail in Simplifying
4 Non-Geographic Numbers, there is actually already an over-consumption effect being
5 created by the mobile tariff package effect?

6 A That's what they say, yes.

7 Q You disagree with that, do you?

8 A That's a completely different question to what we've been discussing so far. The point here
9 is still that I don't think Ofcom are weighing given amounts of consumer harm differently
10 between the two effects; or at least, I don't think they should, and if they are I don't
11 understand why they are. The question you've just asked, Mr. Read, as to whether I agree
12 with the analysis that mobile prices are too high is an entirely different question, and not
13 one on which I have given evidence.

14 Q Is that entirely right, Dr. Walker. Perhaps you can go on to tab 46, which is in bundle C2,
15 which is your second report. Can you go to p.19, and perhaps if we look at para.53 first:
16 "This argument raises a number of questions."
17 You are there addressing Dr. Maldoom's question.
18 "First, if the negative externality is strong, it is legitimate in this case to ask why
19 SPs could not contract directly with MNOs if they wanted to lower the retail
20 prices of 0845/0870 calls originating from MNOs? In practice, SPs have not
21 made such arrangements. This is consistent with the proposition that the
22 externality is not significant."
23 Then at footnote 41 you say this:
24 "I note that Ofcom suggests the externality may be significant in its recent NTS
25 consultation paper, but I am not aware that it provides any empirical evidence in
26 support of this position."
27 And you refer to the Simplifying Non-Geographic Numbers. Now, are you really saying
28 that, in fact, Simplifying Non-Geographic Numbers makes no reference at all, or gives no
29 good empirical reasons why there is a negative market externality in this case?

30 A I certainly don't have any problem with the logic of simplifying numbers consultation as to
31 why there may be a negative externality as a result of these calls. My point here is that, you
32 know, I wasn't, I'm not aware that there's empirical evidence in that consultation. That's
33 not a statement of my opinion as to whether or not the consultation is correct or not. It's
34 just a fairly benign statement about empirical evidence.

1 Q I see. Well, let us move on, shall we, because — can I take you now to your third report,
2 which is at tab.47.

3 THE CHAIRMAN: Sorry, Mr. Read — are you moving on to a different topic, or is this still the
4 same topic?

5 MR. READ: No, I was going to move on, sir.

6 THE CHAIRMAN: In that case I just have a question for Dr. Walker. (To the witness) Let us
7 suppose that the lead position of the NCCNs has a direct effect on, let us say, 080 prices by
8 reducing them for consumers by a certain amount, and let us say that amount is, in
9 aggregate, 100 hours, to keep a nice simple figure in our heads. Let us also suppose that the
10 MTP or waterbed effect is 100 per cent, and so that £100 which is lost to the mobile
11 network operators is regained by charges elsewhere. You equate those two effects. Is that
12 right?

13 A In terms of consumers, yes. Consumers benefit from the lower prices, the direct effect, but
14 there will be disbenefit to consumers from higher prices elsewhere if the waterbed effect is
15 100 per cent. And, broadly speaking, those will counteract it. Whether they exactly
16 counteract, that is slightly different.

17 Q No, but I am putting to you a case where they exactly counteract.

18 A That's fine. Yes.

19 Q It is £100 on each side of the equation, and you say that is the same consumer harm.

20 A Yes.

21 Q But, my question to you is this — is it not clear that it will be different groups of consumers
22 that will benefit and suffer the harm? In other words, it is the users of, in my example, 080
23 numbers who will have the £100 benefit, and it will be a different set of consumers,
24 depending on how the waterbed operates, who will suffer the harm. It could be different
25 handset prices, it could be effects across a whole range of different packages, and so
26 therefore whilst one can say that, in the round, looking at mobile consumers as a whole, it is
27 the same consumer harm, what one has is a re-allocation, even if one accepts that it is £100
28 on either side of the equation, it is different groups of people gaining, versus those who are
29 suffering loss.

30 A Certainly that may well be true. It's an empirical matter as to whether those who make 08x
31 calls also make other mobile calls, but certainly it could be an entirely different set of
32 consumers, as in conceptually. I would still weight those the same, unless there is some
33 other particular reason to be worried about one group of consumers that we can identify.
34 You know, we might be particularly worried, you know, it's something Ofcom mention,

1 that 080 calls particularly hit vulnerable customers, okay. So, we might think, “Oh, it’s
2 good for prices to go down to them”, although of course we would then have to be sure that
3 the prices that go up aren’t also going up for vulnerable customers. So, the starting point is,
4 you weight consumer welfare; as consumer welfare there may be distribution concerns that
5 come in later.

6 Q Yes, and you really anticipated my last question, I think I know the answer, but let me put it
7 to you anyway: is not this question of whether — assuming, as I say, that the equation is
8 equal on both sides and it is £100 gain £100 harm — given the question of whether that is a
9 good thing or a bad thing, actually not so much a question of economics, more a question of
10 policy.

11 A Yes, I certainly don’t dispute that. Yes. I mean, that’s a normative question. I’m just
12 making a positive statement about quantum of consumer harm.

13 Q That is very helpful. Thank you very much.

14 PROFESSOR STONEMAN: While we are in that area, if I could take it one stage further — at
15 the moment we have got, with that example, £100 of gain and of harm, are you denying that
16 the £100 of gain which comes from the lower prices for the 08 numbers does not carry any
17 extra benefit because of the brand enhancement and the removal of the externalities that
18 have been argued about which are associated with, shall we call it “mis-pricing” at the
19 moment of 08 numbers currently? Are you suggesting that there is no extra benefit over
20 and above the benefit that comes from having a lower price for 0800 numbers?

21 A There certainly may be an extra benefit, an extra benefit to the extent that 080 prices are
22 currently over priced. To an extent that is true. There may be an extra benefit. As you will
23 gather from my evidence I’m a little bit dubious as to the exact extent of that, and equally a
24 little bit dubious as to the exact extent to which these WTS schedules will solve that. But,
25 absolutely in principle, you know, I certainly don’t dispute what you say.

26 Q I think that is what Mr. Read was trying to say, whether he accepted that there was that little
27 extra bit or not!

28 MR. READ: Well, I am not going to go back on that at the moment, certainly. (To the witness)
29 Can I now ask you to go to a different topic, and can I ask you to go to tab.47, which is your
30 third witness statement, and ask you to look at para.55, p.16. Do you have it?

31 A Yes, I do.

32 Q And you say there:

33 “The evidence remains, as noted in Walker 1, that there is strong evidence for a
34 substantial waterbed effect, although it is not clear whether in the UK it is 100%

1 or not. My view is that it is likely to be close to or at 100%. This is consistent
2 with the evidence from Genakos and Valletti (2009) and with the fact that the UK
3 mobile market is competitive”.

4 Now, you are relying there, at least in part, for your view that it is likely to be close or at
5 100 per cent on Genakos and Valletti.

6 A Yes.

7 Q And we know, do we not, that Genakos and Valletti did not find 100 per cent waterbed.

8 A They didn't not find 100 per cent waterbed either. What they found in their preferred
9 results is that a 10 per cent reduction in termination rates would lead to a 5 per cent increase
10 in retail rates. Whether or not that is 100 per cent waterbed effect then depends on the
11 relative magnitude of termination revenues as opposed to retail voice revenues. This was a
12 point that Professor Valletti made yesterday; and, certainly if you were to look in the UK,
13 retail voice revenues are substantially greater than termination revenues, so the 10 per
14 cent/5 per cent equation for the UK does suggest actually a 100 per cent waterbed effect.

15 Q What empirical study has been done looking solely at the UK, Dr. Walker?

16 A As Professor Valletti said, no empirical study has been done solely looking at the UK. And
17 it is a good point, you know, this is an average figure across a range of OECD countries,
18 Professor Valletti and Genakos, they do also look at the figure when you divide up their
19 sample by Western Europe, Eastern Europe and others, and then they find actually a higher
20 waterbed effect for Western Europe than for the others. But that's still an average. That's
21 still average across Western Europe. I'm not aware of any, certainly no published study,
22 just looking at the waterbed effect in the UK.

23 Q Well, let us just, have you still got the CAT bundle 13 open? Did you put that back?

24 Again, it is tab.3.1 within that, and if we go to p.176, we see Ofcom's analysis of the
25 various studies. And one sees, at para.8.2.182, that they discuss Genakos and Valletti and
26 add:

27 “They concluded that a waterbed existed, though it was not complete”.

28 Do you see that?

29 A Yes.

30 Q Now, you are disagreeing with what Ofcom say there as a general conclusion.

31 A No, and I think that's consistent with what Professor Valletti said yesterday. He made the
32 point that, when they looked at the effect of MTRs and profitability, and the proposition
33 there would be that if there was 100 per cent waterbed effect then changes in termination
34 rates, it should have no effect on profitability and they found in some of their specifications

1 that reductions in termination rates did lead to some reduction in profits, although they did
2 not find that throughout all of their specifications. So I am not disputing what Ofcom say in
3 terms of how they describe that paper, although again that is an average across the
4 countries, so whether it will be the exact figure for the UK we do not know.

5 Q In para. 55 of your third report that we have just looked at you say: “My view is that it is
6 likely to be close to or at 100%” and then you refer to the Genakos and Valletti study.
7 Now, Genakos and Valletti, the one thing it does not demonstrate is that the waterbed is 100
8 per cent?

9 A What Genakos and Valletti do is they provide a figure for the waterbed effect in terms of
10 changes in termination rates, and changes in retail voice revenues and if you apply that to
11 the UK you do find 100 per cent waterbed effect.

12 Q Sorry, if you apply it to the UK?

13 A Yes.

14 Q But your only proposition for applying it to the UK and you get 100 per cent is the fact that
15 the UK is very competitive, is it not?

16 A No, my proposition, that is just a simple proposition to do with the relative levels of
17 termination revenues and voice revenues in the UK.

18 Q So you are saying that from Genakos and Valletti you can work out what the waterbed is
19 specifically in the UK mobile termination rate market?

20 A Yes, this is not a difficult calculation. What Valletti and Genakos tell us in their preferred
21 result is a 10 per cent reduction in termination revenues will lead to a 5 per cent increase in
22 retail voice revenues. If you look at that in terms of the relative proportions of termination
23 revenues and retail voice revenues in the UK that would give you a 100 per cent waterbed
24 effect. That would show that a 10 per cent reduction in termination revenue is actually
25 slightly less than a 5 per cent increase in retail voice revenues. That is all I am doing.

26 PROFESSOR STONEMAN: If I can just interrupt – it is purely a matter of clarification. When
27 Professor Valletti was sitting there yesterday we asked him about this and he gave us the
28 result it was 10 per cent prices, and 5 per cent prices because he did not have any quantity
29 data. It was not on revenue at all, and when we asked him why he could not calculate the
30 waterbed effect he said: “It’s because I don’t have any quantity data”. If he had quantity
31 data he could have done it on revenues and done the calculation you have. So he was not
32 willing to draw any conclusion with respect to the waterbed effect, all he was willing to say
33 was “We had a 10 per cent change in the termination rate, and a 5 per cent change in the
34 origination price. It was to do with price he told us yesterday?”

1 A No, I agree and I am then applying it to quantities in terms of revenues that we do know
2 about in the UK but I accept that he didn't do that.

3 PROFESSOR STONEMAN: I am sorry, but to me you have somehow implied an elasticity of
4 demand in there somewhere. You are assuming the quantities stayed the same, I think, in
5 order to get that calculation now?

6 A I would accept that, yes. What I am doing is I am looking at the revenue effect of the 10 per
7 cent reduction in termination rates from where they currently are and comparing that to a 5
8 per cent in retail revenues from where they currently are and, you are absolutely right, yes,
9 that does imply a zero elasticity.

10 PROFESSOR STONEMAN: Yes, thank you.

11 MR. READ: If we could just go back to paragraph A2.182, that paragraph starts by saying: "For
12 completeness we also note that there are also a few empirical studies on the waterbed effect
13 in the MCT", do you see that?

14 A Yes.

15 Q You are not suggesting, are you, that that is wrong as a statement, that there are in fact only
16 a few empirical studies?

17 A I am not disputing what Ofcom say, no.

18 Q Because I think in fact Professor Valletti said in terms that his was the only one that had
19 been published as such out of all these papers?

20 A He did say that.

21 Q And so you are effectively, at the end of the day, basing your conclusions on the Genakos
22 and Valletti study? That is what it comes down to. When you say: "My view is it is likely
23 to be close or at 100 per cent in the UK you are effectively basing it primarily on the
24 Genakos and Valletti study?"

25 A That is certainly, I would say, the single most important piece of evidence. Of course,
26 underpinning that is just the basic theory of the waterbed effect and the fact that in an
27 effectively competitive market we would expect it to be high, or at least I would expect it to
28 be high – a point I make in my statement.

29 Q If I can just find my transcript from yesterday, one of the questions I actually put to
30 Professor Valletti on day 8, p.94 line 15 was to ask him whether or not there was a 100 per
31 cent waterbed effect, and he said that no one has the right data to tackle that question, that
32 was his answer yesterday?

33 A Yes, I think your question was in respect of the UK market, and I do not dispute that.

1 Q It is also right that when I asked Professor Valletti, because you were in court you heard the
2 answer but I will give you the transcript reference, it was day 8, p.94 line 23, when I asked
3 him specifically about the differences between the mobile termination rate market and the
4 call origination market he said this:
5 “The analogies are there, of course. What would matter to me at least would be to
6 understand – mobile termination seems to be an example where the magnitude of
7 revenues you make from termination should be bigger. So I would expect a mobile
8 waterbed effect to be higher in the mobile termination rate vis-à-vis this current
9 case.”
10 A Yes, I heard him say that.
11 Q And do you agree with it?
12 A No, I don’t. I was a bit surprised at the time. I disagree with that, it is not clear to me why
13 the nature of competition in the market which means competition between the various
14 operators will tend to push the excess profits out of the market, why that should only affect
15 big numbers as opposed to small numbers. It’s a little bit like saying that a company will
16 only pass on a big cost increase but little costs it will ignore; there is no evidence for that, so
17 I am afraid I do disagree with Professor Valletti.
18 Q I see, so can we just summarise where we are. I think you agree that the Genakos and
19 Valletti study itself cannot demonstrate 100 per cent waterbed effect, does not demonstrate
20 100 per cent waterbed effect?
21 A It does not demonstrate that, no. That does not mean it cannot provide some evidence
22 which is relevant to try and answer that question.
23 Q There is nothing specific in the empirical material relating to the UK market in that paper?
24 A No.
25 Q Anywhere?
26 A No, I don’t think there’s any UK specific study.
27 Q Thirdly, there is nothing been published or considered in relation to the UK call origination
28 market for NTS calls?
29 A Again, as far as I am aware that’s true.
30 Q And yet you say that your view is the waterbed is likely to be close to or at 100 per cent?
31 A Yes, I see, well I think I have put my points.
32 Q Can I ask you now very briefly about the welfare analysis because I think in quite a lot of
33 your reports you effectively say it is a matter of law and there is no point in the economists
34 arguing about whether a better standard to be used in this case is the social welfare standard

1 or whatever. You say that effectively Ofcom has based its conclusions on its interpretation
2 of the law and therefore you effectively stay out of that debate?

3 A That's a very fair summary.

4 Q I only want to ask you one question then, which is in your third report about the diagram,
5 the famous diagram from figure 8 of Mr. Myers' second statement, which is on p.19 of your
6 witness statement, the third witness statement, C2, tab 47, p.19?

7 A Page 19 is my changed version of it.

8 Q I am sorry, if I did not make that clear.

9 THE CHAIRMAN: Page 17 I think is the reproduction.

10 MR. READ: I skipped ahead, sir, and perhaps not actually made clear that I was moving ahead to
11 what Dr. Walker had done. As you rightly say, Dr. Walker, this is your adjusted version
12 which you are effectively putting forward to say "Well, actually if you re-draw it a different
13 way nothing changes"?

14 A Well, I don't say "nothing changes" what I say is that there were four propositions that Mr.
15 Myers was demonstrating, showing in his figure and I have drawn the figure slightly
16 differently so it still shows those four propositions, but the relative magnitudes are different,
17 and my simple point was that I think it is terribly unfair to Mr. Myers to say that I can get a
18 ruler out and actually derive quantitative results from his figure.

19 Q But what your revised figure does actually show, does it not, is that if you draw the
20 gradients differently and you draw where the mobile tariff package effect starts off, you
21 actually end up with different results. Let me give you an illustration of this before you
22 answer the question. By changing the relative gradients and the position of the mobile tariff
23 package effect, effectively what you do is change the tipping point from it being welfare
24 negative to welfare positive along the graph?

25 A Yes, I'll deal with that in two parts. Your first proposition is undoubtedly right, and I can't
26 believe that's controversial, absolutely. If we decide that the waterbed effect is a quarter
27 then that will have an implication for the welfare analysis – undoubtedly true. Then your
28 second point in terms of the tipping effect, since that's not on my diagram, I presume you're
29 talking about what Professor Dobbs has done, the point at which we move from welfare
30 negative to welfare positive along the price axis for 080 calls, absolutely. That's just a
31 repetition of what I've already said. If there is no waterbed effect or it's very small, that
32 affects the welfare analysis, of course. It affects the welfare analysis under Ofcom's
33 approach, it doesn't affect the welfare analysis under the total welfare approach.

1 Q I do not think there is a great deal of dispute about the fact that we do not see anywhere in
2 the final determinations anything that actually addresses, even on a sensitivity basis of just
3 mooting different scenarios, what happens when you do change the gradients and the
4 relative weight that you give to the MTPE. There is nothing in there is analogous to what
5 effectively you have shown by your diagram, and Mr. Myers has shown by his diagram?

6 A I'm not sure I entirely understand, but if you are saying that in the determinations there is no
7 point where it quantifies all of these effects, then that's true, yes.

8 Q I think that is probably as far as I need to go. Can I now ask you to go back to your first
9 expert report on a different point. That is at tab 45, and can you go to para.13, p.4. The
10 point that you are making is that you say that it would be very easy to design a WTS, a
11 wholesale tariff structure schedule, that would definitely incentivise the MNOs to lower
12 prices?

13 A Yes.

14 Q Effectively, and I think we see this from para.12, that essentially would be a linear schedule
15 – in other words, it would not be stepped, it would go up:
16 “For example, Ofcom has noted that a simple WTS that keeps the MNO
17 retention unchanged as retail prices rise would incentivise the MNOs to lower
18 their 080 prices.”
19 That is effectively a linear ----

20 A Yes, a non-step function.

21 Q There are very good reasons, are there not, why BT should not actually be able to do it that
22 way and should have chosen a different way of doing it rather than adopting that linear
23 approach.

24 A Okay.

25 Q You are not aware of them, I suppose, is what we can take from that?

26 A Yes, I'm not aware of those beyond the practical issues that I do mention, and I say they
27 relate both to a smooth function and to a step function. So, no, I'm not aware of any issues
28 that relate purely to the difficulty of a smooth function.

29 Q We know that one of the things you had at the time of this report was a statement by
30 Mr. Richards, because you refer to it in several places. For example, I think we see it
31 referred to in para.15 of that statement. You had it?

32 A Yes, I had Paul Richards' statement.

33 Q Can I ask you then to take bundle C1, and perhaps we should go to Mr. Richard's statement.
34 Also it has not seen much of the light of day in this case it is actually evidence that has not

1 been addressed in cross-examination. Can I ask you to go to tab 16, p.17, para.64. I will
2 give you a chance to read it, if you want to.

3 A Thank you. (After a pause) Okay.

4 Q Those are fair reasons, are they not, for departing from a linear WTS?

5 A I'm sorry, I don't actually understand them. I don't understand why a linear WTS makes
6 wholesale pricing less transparent than a stepped WTS. It still seems that it would be
7 commercially sensitive information between BT and the MNO as to what actually the WTS
8 was that was paid. I don't understand that first point. The second point, if it is the case that
9 a step function would reduce the costs of implementation of the schedule to the various
10 parties, if that was the case that would be a legitimate reason to take into account. I am not
11 aware of why it should reduce the implementation costs. I would note that I have made this
12 point in all three of my reports and at no point has anybody come back and told me why it
13 was wrong. I'm a little bit surprised that it's in dispute.

14 Q You are not suggesting, are you, that, in fact, what Mr. Richards has said there as being
15 BT's motivation for designing the WTS in that way is wrong?

16 A What I'm saying is, I don't understand the first reason, because it just seems to me I don't
17 see why a linear function increases transparency relative to a step function. We are talking
18 about wholesale cost prices here. Of course, the retail prices, BT wants them to be more
19 transparent. I don't know what these grounds of practicality are. I'm not aware of what
20 they are.

21 Q The question I am putting to you, Dr. Walker, is you are not suggesting that that was not
22 part of the reasoning that BT employed when it introduced these tariff charges?

23 A I'm making no comments at all on what BT's reasoning or intentions were at the point at
24 which they introduced the charges. That is not for an economist to comment on.

25 THE CHAIRMAN: Mr. Read, I think what the witness is saying is he cannot comment at all on
26 what Mr. Richards thought. He is commenting on the sense of the motivation as articulated
27 in 64.

28 MR. READ: Absolutely, they are two different points. It seems to me obvious, but I just wanted
29 to make sure that the witness was not saying anything to the contrary.

30 THE CHAIRMAN: I quite understand.

31 MR. READ: (To the witness) So you are saying effectively that, if you have a step function, all
32 that the MNO has to do is to say, "I am located on this step" without specifying the precise
33 price, that has no competitive advantages as far as transparency is concerned ---- If you do
34 not understand the question I will put it again.

1 A I'm not sure who the transparency is meant to be towards. Mr. Richards was suggesting
2 transparency was a bad thing there, and I therefore presume he's talking about wholesale
3 price transparency. I don't see why either type of schedule makes it more or less likely that
4 other MNOs will know the wholesale costs that their competitors are paying.

5 Q Do you understand how the wholesale market actually operates contractually?

6 A I am not sure I understand what you mean by that.

7 Q Well, the contractual relations, for example, between BT and an MNO is governed by a
8 thing called the Standard Interconnect Agreement.

9 A Sure.

10 Q And part of the Standard Interconnect Agreement is a thing called the CPL, the "carrier
11 price list", where prices are listed out.

12 A Yes.

13 Q And so, if you actually have a list within that, and it is a public document because you can
14 actually access it, if you can take long enough to find the link, you can actually access it
15 from the outside, and therefore actually see what prices are actually being charged between
16 respective parties, if you look hard enough, and it is not one of, I think, the accepted
17 categories.

18 A I'm afraid you've lost me here because the WTS schedule is transparent under either
19 approach, you know, whether it's stepped or whether it's linear, it's a perfectly transparent
20 document. Everybody within this room knows what the WTS is, and so I'm not quite sure
21 what the confidential information here is that BT is worried would get shared between
22 MNOs.

23 Q Dr. Walker, if you had to take a linear WTS function, and you say that, I will take an
24 example, O2 is being charged a wholesale tariff price at this point on that linear gradient,
25 right? The only basis upon which it can be charged at that rate is because it is setting a
26 specific retail price, average retail price, for its customers.

27 A Yes, I'm beginning to take your point, although I think the premise is wrong, but — so what
28 you're saying is, if it is public knowledge exactly what the termination rate is each MNO is
29 paying to BT, then under a linear schedule that tells you precisely what their average retail
30 price is, when under a stepped schedule it just gives you a range, okay. I am not aware that
31 the precise termination charge paid by each MNO to BT would be public under this
32 proposal.

33 Q I see. Well, I think I have probably taken that as far as I can, sir.

1 THE CHAIRMAN: Just one question arising out of that, Dr. Walker, perhaps if you move on in
2 the same Richards statement to p.13, it is fig.2.7 which is the schematic of NCCN956.
3 A I'm sorry, which document?
4 Q I hope you are still in the witness statement of Mr. Richards.
5 A No, I wasn't. Sorry.
6 Q It is Vol.C1 tab.16. We were looking at para.64 which was Mr. Richards' reasons for the
7 step approach on the NCCN, and if you move through that statement to p.13 you see a
8 schematic, p.19, I am sorry, I am looking at the annex. I am so sorry.
9 A "Schematic Of NCCN 956".
10 Q You have that.
11 A Yes.
12 Q It is labelled "Figure: A2.7". And if you look, let us say, at the step that is at 21.8ppm, the
13 point that Mr. Richards is making is that if one is paying that rate as an MNO, then one's
14 average retail price will simply lie between 17.5 and 22.5 and you will not be able to tell
15 where within that range it will lie.
16 A If that's the point he is making, then that will be true.
17 Q Thank you. Let us move on to the functional form of the demand curve. And, can I ask you
18 to go, I think we can look at this in your first report, which is tab.45 in bundle C1 at p.10.
19 I think you were in the Tribunal when Professor Dobbs was giving his evidence.
20 A I was for some of it, and I read the transcript for the rest of it.
21 Q Right. Because what he was saying is that a good starting point is to take two assumptions,
22 one of global linearity, one of constant demand elasticity, and effectively test the positions
23 in between.
24 A Yes. He made the point that you can consider them to be polar cases, you know, we don't
25 usually consider that we could have demand curves that are more convex than elasticity
26 demand, although we could, empirically, absolutely, and equally we tend to believe that we
27 don't see demand curves that are more concave than a linear demand curve — although,
28 again, we could. And I think the point was made, and I agree with it, that, and certainly it
29 was in some of the papers that were put to him, when we're doing merger simulation, and
30 these things matter a lot, you know, the standard is you use a linear demand curve for the
31 lowest possible price rise, and the CES curve for the highest possible price rise.
32 Q And so you are accepting that is a normal proposition.
33 A To use these as two polar cases, yes. That's a normal proposition, just a standard
34 proposition.

1 Q So, for example, in this case Mr. Pratt, I think, has come out with figures showing constant
2 elasticity and linear, you would accept that those are the two polar results that one should
3 look at and measure as a result the likely incentives.

4 A No, that's not what I said, no. That's a very different position. I said those are two polar
5 cases often looked at. I mean, I certainly think that, looking at a constant elasticity demand
6 curve doesn't make a great deal of sense for a number of reasons. And, again, if we look at
7 my simulation and particularly actually people who discount it, and the reasons are not just
8 these issues to do with at the extremes, you know, you find there's always some demand
9 however expensive it is, and however cheap it is, as people just buy more and more, but also
10 that there's absolutely no strategic inter-action under a constant elasticity demand curve.
11 You have the odd result. If you assume that all companies face constant elasticity demand
12 curves and they are competing against each other, then if one raises its price the other
13 doesn't do anything because their elasticity hasn't changed by assumption. These are not a
14 demand curve that can work with any sort of strategic inter-action. Now, in a monopoly
15 model such as Professor Dobbs uses, actually that doesn't matter, there's no strategic inter-
16 action. So, in a monopoly model, as a local approximation, it's not an unreasonable thing to
17 look at, but that's very different from saying "Actually this is probably a good description
18 of reality".

19 Q But, can we just actually see what the differences are, if any, between what people are
20 saying about the demand curve, because I think if you accept that the linear and constant
21 elasticity are reasonable boundary cases, it infers, does it not, that you are likely to end up
22 with some convex curve in between them, and that's going to actually probably be the true
23 nature of the demand curve.

24 A Yes. So, if you were taking those as your upper and lower bounds, that's clearly true.

25 Q Yes.

26 A Yes. That you will have some sort of curve in between of some convexity at least at some
27 points. As Professor Dobbs correctly says, "It may vary over the demand curve".

28 Q The other point I think I should put on this, because you mention there about monopoly
29 situations and the like — this is a slightly different situation, is it not, to what you might
30 expect, for example, in the retail market normally, because we know, and Professor Valletti
31 discusses this, that this is actually an after-market. His example is printers and toners, and
32 that may not be necessarily the best example, but it is certainly one that I think the lawyers
33 can get their heads round. But, effectively, it is some form of after-market, that people are
34 not buying on the basis of 08x calls their telephone packages.

- 1 A Yes, whether we call it an after-market or whatever, it doesn't matter, yes, 080 calls,
2 08x calls don't seem to be a prime focus of competition. So, in that sense, of course, a
3 monopoly-type model might make sense. Of course, that then leads to the really big
4 problem that the BT modelling faces, which is when you do that, and you look at prices, and
5 you look at marginal costs and derive elasticity it appears to give an elasticity that the
6 MNOs do not recognise and to the extent there is any evidence on what the elasticity is on
7 the empirical evidence it leads to an elasticity much higher than appears to be in the market
8 place. What that leads you to say is that maybe the MNOs are wrong, or maybe these
9 models are missing something, that is my fundamental concern, that if you go for a
10 monopoly model then the elasticity estimates do not make sense.
- 11 Q Well just so we are clear about this, what elasticity estimates are you talking about?
- 12 A Professor Dobbs derives his elasticity estimates from a Lerner index on the basis that the
13 prices and marginal costs assuming a monopoly model. When he does that he finds that
14 elasticities are greater than one, of course, absolutely right, and then he runs his model on
15 that basis and that is all perfectly fine modelling. The problem is the elasticity that is
16 implied is not an elasticity that the MNOs seem to think they face.
- 17 Q So it comes down to what the MNOs think is what you are relying on for reaching a
18 conclusion that the modelling is flawed in that sense?
- 19 A The modelling is not flawed in any technical sense, the modelling is, I would not say
20 'beautiful and elegant' because that would make me very nerdy. The modelling is, in
21 general, absolutely fine. It seems to be its empirical implication to suggest it is not a good
22 description of reality and, yes, I am basing that on the view of the MNOs as to the elasticity
23 they face, they after all are going to be the people setting prices here. Also, there is a little
24 bit of empirical evidence referred to in the Frontier report from summer 09 I think, or
25 maybe 10, suggesting a market wide elasticity of about minus 0.3, which is dramatically
26 lower than the elasticities that come out of Professor Dobbs' models.
- 27 Q We know, do we not, that we do have some figures for the 080 situation when the
28 Department of Work and Pensions actually effected its deal with the MNOs in order to
29 make sure that all 08 calls were zero priced to anyone calling them. You are aware of that?
- 30 A Yes, absolutely, and we know therefore that for that particular type of call we have an arc
31 elasticity, I think, of minus 2.47.
- 32 Q Anyway, there is nothing else that you are relying upon other than has already been
33 ventilated in the course of this case?
- 34 A In terms of elasticity estimates, no I do not have any back pocket econometric estimates.

1 Q Can I then ask you to go back in your first report to p.6, where you have your figures 1 and
2 2, and you set out the issue of constant elasticity of demand and linear demand in the
3 respective figures, and demonstrate when it is likely to incentivised a price increase?

4 A When on the basis of Professor Dobbs' Dobbs 3 model it is likely to incentivised a price
5 increase.

6 Q Absolutely, a fair qualification. But the starting point for this is that you use a number of
7 ranges for marginal costs between 1 and 5ppm?

8 A Yes, I was quite amused by this testimony. What I have done is use exactly the same
9 figures as Professor Dobbs used. Professor Dobbs, in his Dobbs 4, used marginal costs of 1,
10 3 and 5, and he used a range of starting prices; I just repeated that analysis.

11 Q The point is though that certainly now we know that the 1 to 5ppm marginal cost figures are
12 actually likely to be the wrong range, do we not?

13 A Yes, there is good evidence that marginal costs are towards the lower end of that range,
14 absolutely.

15 Q Under 1ppm?

16 A No, I am afraid I would disagree with that, but that is a different dispute.

17 Q Let us just see where I am getting the figure from. Can I take you to CAT bundle 13 ----

18 A If we are really going to talk about whether the marginal cost is close to 1, between 1 and 2,
19 then I am happy to agree with that, whether it is less than 1 I am not going to say "yes" to
20 that.

21 Q I am keen that we just see what Ofcom are actually saying about this, and perhaps if you
22 can take CAT 13, tab 3.1 and can I ask you to go to p.330. We see a footnote there, 594:
23 "For illustrative purposes, mobile OCPs incremental costs may be in the region of
24 0.5 to 0.7ppm. This consists of an assumed incremental cost of retailing of 0 to
25 0.2ppm (the same as for both fixed OCPs – see the preceding footnote). The
26 incremental network cost of mobile origination has assumed to have been 0.5ppm.
27 We note that this is broadly in line with the 2010 Mobile Termination
28 Consultation, which estimated a pure LRIC ..."
29 which, for these purposes equates to marginal costs "... of termination in the region of
30 0.5ppm", and it sets out the reference there. So that is where I am suggesting that the figure
31 may be below 1ppm. You do not accept that that is so?

32 A I absolutely accept that the MTR recent decision has purely on prices actually knocked
33 down the 0.5, but below 1 at this stage falling to 0.69 over the next few years, marginal

1 costs are low, I am not going to say that I think Ofcom's analysis in the MTR dispute is
2 entirely correct.

3 Q I see, well at least we know where you are coming from on this. But if we actually focus in
4 that range between 1 and 2ppm marginal cost, we see it is actually – I understand the point
5 you are making about what you were replying to at this stage when you wrote your expert's
6 report, and we all, in this case I think wanted to avoid the archaeology of going into what
7 was being said at what point and by whom, but the reality is that if one, for example, takes a
8 marginal cost of 1ppm, it looks as though from your figure 1 that if you assume constant
9 elasticity you are well over 40p before there is any chance of there being an increase in
10 costs?

11 A Yes, so for a marginal cost of 1 any initial price of 40 or less, and assuming you can then
12 derive the elasticity estimate from that price and marginal cost then, absolutely right, the
13 Dobbs' model implies that prices will fall.

14 Q And the other boundary case of linear demand in figure 2, even at 1 we are probably
15 looking at about 31ppm for it to actually have an effect of incentivising an increase in
16 prices?

17 A Yes, subject to all the caveats I just gave.

18 Q Can I ask you another question ----

19 PROFESSOR STONEMAN: Mr. Read, before you move on to there, the content of footnote 594
20 I think is an important piece of information to which we have not actually been pointed
21 before. If nothing else it refers to Principle 1, and as such it will be an important number for
22 us to consider when we come to our judgment, and as such I am somewhat reluctant to rely
23 on footnote 594 in a document that starts off: "For illustrative purposes ..." as a piece of
24 evidence. Are we going to get more submissions upon what this figure should be? Are the
25 other parties going to be responding in any way? In fact this does refer, the Mobile
26 Termination Consultation, to documents I do not remember seeing in our pile, I do not
27 know if they are there or not, and I am wondering if it is a piece of evidence that we should
28 be emphasising or not emphasising, or whether the parties find contentious.

29 MR. READ: Can I say this, sir? I do not think I took the Tribunal specifically to that footnote,
30 but I certainly did refer in opening to the issue of marginal costs, and in fact I think I took
31 the Tribunal to a different point in the Simplifying Non-Geographic numbers, where they
32 deal not just with marginal cost but they also deal with the costs if you actually distribute
33 some of the fixed costs as well. I am just trying to find the reference to that. But certainly I
34 know in opening, and if necessary it can be checked on the transcript, I made the point

1 about the marginal costs at that stage; it may have been slightly lost in the rather lengthy
2 opening that I gave, but I am absolutely certain that I took the Tribunal to it. I cannot
3 immediately lay my hands ----

4 PROFESSOR STONEMAN: Would you like to just return to it in your closing?

5 MR. READ: I certainly will. I cannot exactly remember the reference. I will not bother to spend
6 time looking for it now, but I will try and flush the point out.

7 THE CHAIRMAN: If you can find it in the course of one of our breaks that would be helpful.

8 MR. READ: I want to check on that before I give an answer specifically on it. (To the witness)
9 Can I ask you to look at another table that you have produced, which is in your second
10 report, bundle C2, tab 46, p.5, which Professor Dobbs was cross-examined about yesterday.
11 Do you have your table there?

12 A Yes.

13 Q I think you accept, do you not, in footnote 5 at the bottom there, that the results in table 1
14 are consistent with Neil Pratt's results in his statement that we have seen, and in particular
15 the material at annexes 1 and 2 of his statement where he sets out material on what happens
16 if you have an assumption of constant demand ----

17 Q Yes, I agree with Neil Pratt's analysis.

18 Q I just want to be clear, because in calculating this what you have actually done is take a
19 number of scenarios and said how many of the scenarios create a reduction down to 12.5
20 ppm, and how many obviously do not, and that is how you end up with your percentage
21 figure there, as I understand it.

22 A Yes.

23 Q I just want to see how you actually did this in terms of scenarios. Obviously, when one is
24 looking at the marginal cost you certainly are talking there about marginal costs as high as 5
25 ppm in the paragraph. I am just trying to see, did you use the same basis of 1 to 5 ppm
26 marginal cost for actually calculating your various scenarios?

27 A Yes, and if I haven't made that clear in the report then I apologise. I thought I had.

28 Q I am not criticising you for it, I am just trying to understand how you have reached the
29 figures in 13. What effectively you have done, if I have understood this correctly, is you
30 have taken the various scenarios with the starting pre-NCCN ARP, you have then taken
31 various scenarios about the marginal costs that might be included, and therefore you have
32 ended up with a series of percentages saying which numbers of scenarios actually force
33 12.5p and which do not?

34 A All in the context of Professor Dobbs' models.

1 Q Yes, I understand that. In fact, the marginal costs of 5 ppm or 4 ppm or 3 ppm are wrong,
2 then a number of your scenarios fall away?

3 A Yes, of course.

4 Q Can I ask you to turn to your second report, tab 46, bundle C2, and can I ask you to go to
5 p.8. Here you discuss Professor Dobbs' fourth report. You start off in para.20 by looking
6 at the sixth report and then talk about the discussion of the fourth report. Do you see that?

7 A Yes.

8 Q You then, through that, start talking about the spill-over effect, which I think everyone
9 accepts in this case the Dobbs 4 report added into the modelling?

10 A Yes.

11 Q You go through some discussion about that. You conclude at the end of para.21:
12 "In my view, his model ..."
13 the model there is the Dobbs 4 model –
14 "... cannot be considered to be reliable or to be an improvement on Dobbs 3."

15 A Yes.

16 Q That is your view, is it?

17 A Yes, it is my view. The problem with the Dobbs 4 model, and I think Professor Dobbs
18 himself yesterday said he ended up saying he preferred Dobbs 3, is it deals with the serious
19 problem of why does Dobbs 3 give an elasticity that nobody believes in, and he says,
20 "Okay, we will add in a spill-over effect", perfectly sensible. We are in a position where
21 nobody appears to believe that spill-over effect is significant, so it cannot possibly be an
22 answer to why does Dobbs 3 give an elasticity that nobody believes. In addition, I do not
23 like the way the spill-over effect is modelled, because there is not strategic interaction
24 between the companies, and it seems to me any spill-over effect would have to include it.
25 This is something that Professor Dobbs has looked at in Dobbs 7, annex 5. I would say he
26 still has not solved that problem. I don't think he's solved it at the modelling level, but
27 more fundamentally nobody still believes spill-over effect is important or is large.

28 Q Can I just ask you to look at bundle B1, tab 1, which is the final determination, and can I
29 ask you to go to annex 3 which starts on p.191. Do you have that?

30 A Yes, I have annex 3.

31 Q Annex 3 is a section of the draft determination, so what we are looking at here is effectively
32 the draft determination. Do you understand?

33 A Yes.

34 Q Can I then ask you to p.224 and look at para.5.162 Do you have that?

1 A Yes.

2 Q We see what the conclusion of Ofcom was on the direct effect at the time of the draft
3 determination?

4 "In light of the available evidence we consider that the direction and magnitude
5 of the Direct effect of NCCNs 985 and 986 is uncertain."

6 Do you see that?

7 A Yes.

8 Q That was before Dobbs 4 had been introduced. As a matter of history, that is correct.

9 A Okay.

10 Q Following Dobbs 4, Ofcom then produced a supplementary consultation. That is in annex 4
11 of this final determination, which is p.261. It sets out the Supplementary Consultation to
12 resolve the dispute, do you see that?

13 A Yes.

14 Q Can I ask you to go on to para.2.131, p.291 ----

15 A I am sorry to interrupt. This is the supplementary consultation? This annex 4 is the
16 supplementary consultation?

17 Q Yes.

18 A Okay. I thought the supplementary consultation had Dobbs 4 attached to it.

19 Q Yes, that is absolutely right. Let me just be clear about the chronology. The draft
20 determination comes out, and in response to the draft determination Dobbs 4 is produced,
21 because one of the criticisms is that Professor Dobbs and Mr. Reid's modelling does not
22 take into account the spill-over effect.

23 A Okay.

24 Q Dobbs 4 is then received by Ofcom and considered, and at that point they produce this
25 supplementary consultation?

26 A Yes.

27 Q If we go to para.2.131 in that annex 4, p.291, we see a representation of what Ofcom have
28 said about the conclusion they reached in the draft determination. It says:

29 "In the Draft Determination we reached the provisional conclusion that we were
30 uncertain about both the direction and the magnitude of the Direct effect. As
31 explained below, in the light of the submissions received in response to the
32 Draft Determination we have revised our view on the direction of the Direct
33 effect. We now consider, on the evidence currently available to us in this

1 Dispute, that 0845/0870 call price reductions are more likely than price
2 increases”.

3 And then they say:

4 “However, as discussed below, we remain of the view that the magnitude of the
5 direct effect is uncertain”.

6 And then they go on, in para.2.132 in discussing the direction of the direct effect. As you
7 can see, they make clear that BT’s models provide a coherent economic theory with the
8 result suggesting that the MNOs will have an incentive to reduce their 0845/0870 prices.

9 And then in 2.133:

10 “In this regard, we consider that Dobbs 4, building on BT’s previous 080 papers,
11 has identified and, using numerical simulation, quantified an effect that is relevant
12 to the Dispute”.

13 And they go on to discuss the incentive of the structure. And then if we see the conclusion
14 at 2.136:

15 “In summary, whilst we cannot exclude the possibility that the proposed tariffs
16 could result in an increase in 0845/0870 call prices, we consider that the balance
17 of the available evidence suggests that it is more likely that the MNOs have an
18 incentive to reduce these prices than to increase them. Therefore our revised
19 provisional conclusion is that it is more likely the Direct effect has a positive
20 rather than a negative impact on consumers”.

21 And that is the conclusion that carries through to the final determination.

22 A Yes.

23 Q So, the point I am putting to you is that Ofcom did not consider that Dobbs 4 was not
24 reliable or an improvement on Dobbs 3. They plainly did think it was an improvement on
25 Dobbs 3.

26 A Yes, Ofcom plainly did think it was an improvement on Dobbs 3.

27 Q But you do not.

28 A I think it is an improvement in the sense that it attempts to deal with an anomaly that comes
29 out of Dobbs 3. It’s not an improvement in the sense that the way it does that is it has to
30 postulate an effect that, again, empirically people don’t seem to believe exists. So, again,
31 the modelling is fine, you know. But it doesn’t seem to be a good description of reality.

32 Q I see. So, the blunt fact is you think you gain nothing from Dodds 4, whereas Ofcom did
33 think they gained something from Dobbs 4.

1 A It may be I misunderstood Professor Dobbs' evidence yesterday, but I got the distinct
2 impression he himself didn't feel that Dobbs 4 actually added significantly to Dobbs 3, but
3 reading the transcript —

4 Q Well, we can have a debate about that but — I do not believe that was the effect of his
5 evidence, but I don't think that is a matter for you.

6 A Certainly.

7 Q Thank you, Dr. Walker.

8 MR. HERBERG: It affects the deliberations on that side of the room, but all that matters which
9 I might have wanted to put to Mr. Walker have been dealt with, Dr. Walker, by BT. So,
10 I do not wish to cross-examine.

11 MISS SMITH: I have no questions in re-examination. Thank you very much, Dr. Walker.

12 PROFESSOR STONEMAN: Could I, I have a couple of follow-ons. First of all, you stated that
13 you have doubts about the validity of the constant elasticity demand curve because, when
14 rivals change their prices there is a problem. Is that what you said?

15 A No. The point I was making was that the constant elasticity demand curve doesn't really
16 allow for strategic inter-action because — and we see this emerges in later models — if you
17 make that assumption, if the model suggests that the merging parties are going to raise their
18 prices, it ought to suggest that nobody else changes their prices; and that's just a surprising
19 result, because we would normally believe that if a competitor raises its price you would, to
20 some extent, follow suit. This is just an effect of assuming that, you know, elasticities are
21 constant, so that a change in the price of your competitor does not change your elasticity, it
22 doesn't change your profit maximising —

23 Q So the change in the price of the competitor will shift the demand curve. The elasticity of
24 the demand curve is what happens if you move along.

25 A Sure.

26 Q What you are talking about is whether the elasticity is maintained, the demand curve, from
27 one position to another. I think that is a different issue.

28 A Okay.

29 Q That is a cross-price elasticity —

30 A No, I take that. I take that.

31 Q All right. The second question is this question of whether the spillover is significant, and
32 I did explore that both with Professor Dobbs and Professor Valletti yesterday afternoon.
33 I thought we came to some sort of an agreement that there were spillover effects which was
34 how the impact of 0800 prices affected the choice of mobile operator, and we all agreed that

1 was too small. But also included in the spillover, either included in the spillover or as a
2 separate effect, was the tariff rebalancing, because if mobile operators are going to tariff
3 rebalance every time they change a price, I mean, the importance of that is reflected in the
4 TPE, that could be significant; and so that need not be empirically irrelevant in the pricing
5 decision.

6 A No, I certainly agree with that. No, when I was talking about the spillover analysis, I was
7 explicitly talking about here spillover effects as opposed to a waterbed or mobile tariff
8 package effect. I had understood those to be distinct.

9 Q Right. But the spillover effect, as modelled in Dobbs 4, could include the waterbed effect.
10 That was his view, anyway.

11 A I don't think that's something, I need to dispute. A spillover includes the waterbed effect,
12 you know, then we're moving towards the MTPE and, yes, I've already said I think that's
13 an important consideration to take into account.

14 Q All right. Thank you.

15 THE CHAIRMAN: Dr. Walker, thank you very much.

16 MR. READ: Sir, can I just leap to my feet at this point while Dr. Walker is leaving the witness
17 box, and just give you the reference where I mention the marginal costs in opening.

18 THE CHAIRMAN: Yes, please.

19 MR. READ: It is Day one, p.19, and in particular. I think, lines 4-19; and, in particular, I took
20 the Tribunal to para.6.127 in Simplifying Non-Geographic Numbers which, as you know, is
21 in CAT bundle 13, tab.3.1, and I think is on p.94.

22 THE CHAIRMAN: Thank you.

23 MR. READ: Sir, I wonder if that might be a convenient moment before the next witness is called.

24 THE CHAIRMAN: I think that would be sensible. We will rise for five minutes.

25 (Short break)

26 THE CHAIRMAN: Before we resume with the witnesses, on marginal costs the 080 final
27 determination, and I think the other final determination, seems to proceed on the basis that
28 marginal costs are of the order of 5 ppm – for example, para.5.112 in the 080 determination.
29 I think it is clear that that is based on an absence of data and the final determination makes
30 that fairly clear. I infer therefore that the ----

31 MR. READ: What is the paragraph, sir, that you ----

32 THE CHAIRMAN: One example is 5.112, p.60.

33 MR. READ: The reason why I am hesitating, sir, without reading it is because, of course, one has
34 to be very careful about drawing the distinction between the costs or origination, which of

1 course include an element of fixed costs, and the marginal costs, which is what
2 Professor Dobbs was dealing with.

3 THE CHAIRMAN: I see that, and you are absolutely right, Mr. Read, 5.112 does not draw that
4 distinction. I think, although I am bound to say I have not been able to find the reference,
5 there is a reference to a 5p marginal cost in the 080 determination. I may be wrong.

6 MR. O'DONOGHUE: Sir, I think the phrase was, "unlikely to exceed 5 ppm".

7 THE CHAIRMAN: It was referred to as an assessment, given there was a distinct absence of
8 data. The inference from the figures that you are giving us now in the later study is that
9 there has been more research done and it seems clear that the marginal cost is rather lower
10 than 5 ppm. That is what I understood Dr. Walker to be agreeing with.

11 MR. READ: I think the position in the 080 case is that, of course, the Reid 1 and the Dobbs 3
12 modelling have not been done. So the issue of marginal costs was not a high focal point in
13 the course of the 080 determine. Of course, that is one of our concerns about what actually
14 happened in the 080 determination and what we say was the misleading impression that
15 Ofcom gave to us as to what the scope actually was.

16 I think it is fair to say that the 080 determination was not focused on the question of
17 marginal costs, and therefore if it does arise in the course of the 080 determination it arose
18 in the context of discussing the Principle 1 question of the costs of origination.

19 THE CHAIRMAN: Again, you are absolutely right. I am sure that you are right that it is in
20 connection with Principle 1, and it may be that things moved on even in the 0870 final
21 determination. I am just reiterating Professor Stoneman's concerns about the potential
22 importance of this figure. I anticipate that it will be helpful to have a list of references as to
23 the marginal cost that we do have in evidence for the purposes of our judgment.

24 Miss Smith?

25 MISS SMITH: May I just make the position clear for the three MNOs who are here. Obviously
26 we will develop this in submissions and give you the references that you require. Our
27 submission is that a proper starting point must be the findings in the Ofcom determinations,
28 and in the 080 determination, as Mr. O'Donoghue has said, the only finding was that it was
29 unlikely to exceed 5 ppm.

30 In the 0845 determination our understanding is that no conclusions were drawn by Ofcom
31 as to what the actual marginal costs might be. It was found not to be necessary for that
32 determination.

33 Various figures are now, at a very late stage, being bandied around as to what marginal
34 costs might be. All I can say is that what marginal costs might be as a matter of fact is a

1 very controversial issue, and the references that were made by Mr. Read in cross-
2 examination to the SNGN consultation were to figures produced in the mobile termination
3 rate consultation paper, so they are figures that obviously are still very controversial, but we
4 will be making full submissions on what the relevance of those marginal costs figures might
5 be.

6 THE CHAIRMAN: That is helpful, Miss Smith. In a sense, there are two questions. First of all,
7 there is what appears in the documentation; and then secondly, there is the weight that we
8 attach to, as you say, figures that do not appear in the two determinations which are being
9 appealed to us, but in other documentation, but also to include the evidence that Dr. Walker,
10 himself, gave in the witness statement just now.

11 MISS SMITH: And the evidence that was given by Professor Dobbs yesterday.

12 THE CHAIRMAN: Of course.

13 MISS SMITH: And what impact those figures might have on the modelling produced by
14 Professor Dobbs and therefore feeding into the direct effect. I am not quoting directly from
15 the transcript, but my recollection is that Professor Dobbs, for example, made the point that
16 a reasonable range of marginal costs might be zero and 3 ppm. We may not agree with
17 that, but if that is the case, even on those figures we would say, from his modelling on direct
18 effect, matters such as the shape of the demand curve make a great deal of difference to
19 what comes out of the model at the end of the day as to whether or not prices will fall to
20 12.5 ppm. So, there are a number of issues, obviously, on that.

21 A No, that's plain, I think it was simply the contrast between the 5ppm that we had in our
22 minds and the figures that Mr. Read was quite properly putting to the witness. That was a
23 start point. Mr. Ward.

24 MR. WARD: Sir, I would adopt everything that Miss Smith just said, but I would go a little
25 further, which is to say that it is a highly contentious issue. The MNOs have views not
26 necessarily shared by Ofcom. It has not been litigated in these proceedings. There are
27 plenty of other issues because, of course, we have been here, at least on the part of
28 Vodafone, essentially supporting Ofcom in defending its decision. Now, I am sure nobody
29 really wants to open up a new front in this case, but we certainly would not respectfully
30 suggest it would be appropriate for the Tribunal to proceed on any one of the sets of figures
31 that are in the papers without it being litigated. Our submission, I think rather like
32 Miss Smith's will be that is not necessary. But, should it become necessary, I think with the
33 greatest reluctance we would have to say we need to be heard in some detail on that issue.

34 THE CHAIRMAN: I think we are straying now into matters that are relevant for next week.

1 MR. WARD: Yes.

2 THE CHAIRMAN: But, thank you for making the point clear.

3 MR. WARD: Thank you.

4 MR. O'DONOGHUE: Sir, the only thing I would add is, in fairness to Dr. Walker, his written
5 evidence did not cover costs at all. He simply operated on the assumption parameters
6 undertaken by Professor Dobbs.

7 THE CHAIRMAN: No, he made it absolutely clear he was simply following through a range
8 zero to 5ppm that was used in the modelling of Professor Dobbs, and I quite understand
9 that, but nevertheless he did articulate some views in the witness box. Thank you. Shall we
10 proceed?

11 MISS SMITH: Sir, if I can call Paul Franklyn Anton Muysert.

12 THE CHAIRMAN: Yes. I am so sorry, Mr. Herberg, did I cut you off? Were you wanting to say
13 something?

14 MR. HERBERG: I did not want to contribute to the general debate. I think, for next week, it is
15 being pointed out by those behind me that we think 5.102 makes it clear it is not dealing
16 with marginal costs, it is dealing with the efficient cost of, efficient call origination costs.
17 So, that may be something, I would rather deal with all the references in due course and set
18 out, as far as we can see, how Ofcom proceeded, and what is now in evidence separately.

19 THE CHAIRMAN: Yes, I think this is rather —

20 MR. HERBERG: — jumping at one.

21 THE CHAIRMAN: I think proceeding on the hoof like this is probably less helpful than —

22 MR. HERBERG: Sir, yes indeed.

23 THE CHAIRMAN: But I wanted to raise the point so that the parties were aware of our thinking.

24 MR. HERBERG: Sir, yes.

25 THE CHAIRMAN: Thank you very much.

26 Mr. PAUL FRANKLYN ANTON MUYSSERT, Affirmed
27 Examined by Miss SMITH

28 MISS SMITH: Your name is Paul Franklyn Anton Muysert.

29 A That's correct.

30 Q And your business address is 70 Cavendish Square, London W1G 0PH.

31 A That's correct.

32 Q You should have in front of you a bundle, C2, can I ask you to turn to tab.36 of that bundle.

33 A Yes, my first witness statement.

1 Q And that is your expert report of 8th October 2010, and if I could ask you to turn to p.16 of
2 that report, is that your signature?

3 A That is my signature.

4 Q Can you confirm that is the evidence that you wish to give today?

5 A It is, yes.

6 Q At the next tab, tab.37, your expert report of 20th October 2010 and that at p.4 can you
7 confirm that is your signature?

8 A Yes, that is my signature.

9 Q Again, can you confirm that the evidence contained in that is your evidence?

10 A It is, yes.

11 Q And finally, at tab.38, we have your third expert report of 25th February 2011, and if you
12 can turn to p.39, I am not sure if that version is signed.

13 A Actually it is, I think it is an original. That is my signature.

14 Q It is, that is good, and can you confirm that that is your signature.

15 A That is my signature.

16 Q And is there anything that you want to clarify or correct in that statement?

17 A If I could, actually, just one small point at p.30.

18 THE CHAIRMAN: Which statement?

19 A It is the third statement, p.30, para.60A which is the top of p.30 starting:
20 "Most callers have access to fixed networks".

21 The next sentence reads:
22 "This in turn implies that call volumes lost from the NTS platform as a result of
23 externalities may not represent real welfare impacts".

24 I'd just like to change that to read:
25 "This in turn implies that NTS call volumes lost from the mobile platform as a
26 result of externalities may not represent real welfare impacts".

27 So, the point is that it is NTS calls that are lost off the mobile platform.

28 MISS SMITH: Thank you, Mr. Muysert. And, subject to that correction, does this represent your
29 evidence?

30 A It does.

31 Q Thank you. You will have some questions, I think, first, from Mr. Herberg for Ofcom.

32 MR. HERBERG: Sir, yes, it has been agreed that I will go first, and then I think it is Miss Lee for
33 British Telecom will follow to the extent necessary.
34

Cross-examined by Mr. HERBERG

- 1
- 2 Q Good morning, Mr. Muysert.
- 3 A Morning.
- 4 Q Can we start in your first statement, please, in tab.36. In the first part of your statement you
- 5 discuss the virtues of cost-oriented pricing in terms of economic theory.
- 6 A Yes.
- 7 Q And in particular para.5, I think, you say that cost oriented pricing ensures that:
- 8 “Consumer benefits are maximised by ensuring that all callers have the correct incentive to
- 9 complete calls that have a value to the caller that is higher than the cost of providing [that
- 10 service]”
- 11 That is how I have understood it so far, yes. And, in that scenario there is no inefficient
- 12 wasteful consumption where consumers value the services at less than the cost of the
- 13 resources consumed. But, on the other hand, prices are not set so high that consumers
- 14 consume too little relative to the socially optimal level.
- 15 A Yes, that’s correct. Yes.
- 16 Q And in para.5 you are talking about the prices that consumers pay, the retail price.
- 17 A Yes, that’s correct. Yes, I would say.
- 18 Q Yes, and above that, just before that, in para.3 you are describing the process whereby in a
- 19 competitive market the price of a service tends towards the cost of provision of the service.
- 20 A Yes, that’s right, yes.
- 21 Q Yes. And then, in para.8, you come on to talk about cost oriented interconnection prices,
- 22 and you say that:
- 23 “Assuming the ... (retail) market is competitive”
- 24 then setting costs oriented interconnection prices ensures that:
- 25 “callers pay a total price ... that reflects the costs that would be expected if both
- 26 the originating and terminating markets were fully competitive”.
- 27 A Yes, that’s correct.
- 28 Q Yes. Now, in the current, in other words, pre wholesale tariff schedule retail market for
- 29 mobile originated 08 calls, you would not claim, would you, that the retail prices paid by
- 30 customers reflects the costs of providing the originating and terminating 08 services, would
- 31 you?
- 32 A That’s quite a big question.
- 33 Q Yes.

1 A I guess I should say a number of things. The first is that I haven't been asked to opine on
2 whether or not the 080/0845/0870 retail prices are correct. So, I haven't been asked to
3 opine on that. My view, which I think is in my statements, is that the mobile networks
4 compete over bundles and therefore the correct test really is a total revenues bundle versus a
5 total cost. I haven't been asked to opine on it, but I'm aware that others have opined that
6 that is unlikely to be excessive, and certainly previous work I've done in the UK market
7 would suggest to me that that is not excessive. So, I don't hold a view on whether or not the
8 retail price is correct. I am aware of Ofcom's concerns in the retail market, that's absolutely
9 true, and it is correct that the statement assumes that things are good in the retail market,
10 and that it is possible that that is not the case.

11 Q But leaving aside bundle at the moment and if one is just looking at the actual 08 markets, I
12 am aware that you have not, as it were, done any detailed research work on that but the
13 basic facts in this case are pretty blindingly obvious, are they not? We are talking of
14 average retail prices of somewhere in the region of 10, 15, 20, 30, 40p depending on which
15 provider and whose estimate, but certainly we are talking about between 10 or 15 at the
16 lower and 40ppm retail prices, are we not?

17 A Yes.

18 Q That is one side of the line, is it not?

19 A That's correct, I'm aware that that's the case, and I'm aware that Ofcom are unhappy with
20 that and that they have policy concerns in that area.

21 Q Leave aside Ofcom's policy for now, but just looking at where the market is compared to
22 your, as it were, economic theory and praising of the virtues of cost-oriented pricing. So on
23 the one hand we have ARPs in that region, as the ARPs accept. On the other hand we have
24 to add together the MNOs costs of origination and BT's costs of termination. MNOs' costs
25 of origination we have just been to some extent debating, but certainly 5ppm would be an
26 upper band, it would be potentially quite a lot lower than that?

27 A Yes, well I think we are talking about different things here. The cost of origination that is in
28 dispute – or perhaps not – between the experts of 1 to 5ppm is the marginal cost of
29 origination and I think if I might say the issue there is what is the marginal cost that should
30 go into the modelling for the welfare analysis? I have not gone into that in depth in this
31 proceeding. However, in terms of is the price excessive, the question there really is the
32 total pricing in the bundle as a whole and there is a very large amount of costs in the mobile
33 business that is not at marginal cost, so I do not think we can easily look at the marginal
34 cost of origination of any particular call and then infer whether or not the retail price is

1 excessive. There are issues of Ramsey pricing, elasticities of demand, the profitability of
2 the industry as a whole, these are wider issues, so I don't hold a view ----

3 Q No, I certainly was not trying to affect the marginal cost figure that was just mentioned,
4 even on a fully allocated basis I suggest to you that the evidence is that 5ppm, something in
5 that region, is looking like the cost levels for mobile origination?

6 A To be clear I haven't gone in depth into what is that figure. I did note in Mr. Myers' first
7 statement that in those figures in the 080 dispute there had been some submissions from the
8 operators and that the regulator had taken a view on which retail costs were appropriate, so
9 my understanding, and please correct me if I am wrong, my understanding is that that figure
10 would involve some exclusions, so it is not clear to me that we can draw too much in terms
11 of the average cost.

12 Q I am being very rough and ready, I will not get bogged down with figures. Certainly BT's
13 costs of termination are very low, certainly the final determination, 0845 determination
14 would suggest between 0.2 and 0.56ppm?

15 A That sounds reasonable for a fixed operator.

16 Q So there is, unless the 5ppm is wildly wrong, a very large gap at present between prices that
17 MNOs are charging, at least on an average basis and the aggregate costs of origination and
18 termination?

19 A There is no dispute and I would not dispute at all that there is a significant margin there,
20 gross margin. I don't think it's easy to then infer how that relates to over profitability of the
21 industry, or whether you should consider it ----

22 Q Because of course there are waterbeds and everything else, and bundles etc.?

23 A The fact that the UK mobile sector is one of the least profitable mobile sectors in Europe.

24 Q Indeed, but what one can say, if one is just looking at 08 prices, on your theory consumption
25 of mobile originated 087 numbers is likely to be below the optimum level?

26 A I wouldn't like to offer an opinion on that. I haven't been asked to delve into what the right
27 price for 080 is. I think that's a complex issue. I have to say I've found this an extremely
28 interesting case, at the risk of being a little nerdy, the modelling here has been quite elegant
29 and quite interesting, but in terms of advice to my client one of the things that struck me is
30 that the modelling is largely static, so what I mean by that is it is all short term, it does not
31 take account of the dynamic effects that really dictate the way that the telecoms framework
32 works as a whole, as a policy document. But perhaps more fundamentally one of the small
33 elephants wandering around the room that I've tried to bring out in my statements is the
34 concern that the MTS platform is not a platform, that it is reasonable to call it a platform in

1 general terms, but actually it is a value-added service sitting on top of existing networks, it's
2 a call type within the UK networks as a whole, so it is quite difficult, I think, to look just at
3 one of the calls-type and make strong conclusions about efficiency or consumer impacts. I
4 did provide evidence in my statement based on an Analysys Mason study for Ofcom which
5 suggested that there might be quite strong substitution from the mobile network to the fixed
6 network for 080 in particular, so it's possible that those calls that are lost off the mobile
7 network are not lost to the UK economy as a whole. It is a complex issue and I have
8 concerns that this very detailed modelling is focused on a subsidy of the new work and as
9 such is incomplete.

10 Q I see that. I was not, certainly when I was putting that to you, was not basing it on any deep
11 delving into it, I was applying your general principle set out in the first part of your
12 statement. Let me put it this way, if it is legitimate to look at the 08 market as a separate
13 sub-market, or whether or not it is a separate platform, that may or may not matter, but if it
14 were legitimate to look at that subset of originating calls alone, then on your basic theory as
15 set out it would be the case, would it not, given that retail prices are above cost effectively,
16 that the consumption of mobile originated 08 services would be likely to be below the
17 socially optimal level on your theory?

18 A Yes ... that's certainly the case if you just ... overall approach to look at 080 calls that the
19 volumes would definitely be lower than if they are at marginal cost, but I do not think you
20 can conclude on that basis that they are excessive because the industry has to recover all its
21 costs.

22 Q One of the many considerations would be, as it were, what is happening to those excess
23 profits effectively on 0845 and whether they are being ploughed back into something else
24 that raises welfare benefits somewhere else, for example, the waterbed effect that we have
25 looked at?

26 A Yes, absolutely and whether there's anything that's actually classified as excess in the first
27 place.

28 Q But I principle, again looking just at that market, it would be desirable, would it not in
29 principle if those retail prices – the 08 retail prices – reduced so as to be closer to the cost of
30 providing that originating and terminating service, even if that meant that costs of some
31 other service that was currently being subsidised through a waterbed were to rise, because
32 you would be removing a distortion from the market?

33 A It could be. As a matter of economics I can't easily answer that. I think to answer that
34 question I would need a model of 080 calls and the other calls I'd need to estimate the

1 elasticities, take a view on the waterbed effect, and calculate potential changes in consumer
2 surplus and/or dead weight losses, depending on whether it was a total surplus or a
3 consumer surplus test that I was instructed to use, so I can't tell you easily what the answer
4 to that is because I haven't undertaken that investigation.

5 Q Ofcom has reached the conclusion, as you know, that there is effectively a market failure
6 here, that prices are not being set at a socially optimum level, and indeed has a policy
7 preference which translate through to a bias in favour of rebalancing, has it not?

8 A Yes I'm aware of that policy preference and I think whether that is appropriate is an issue
9 for the Tribunal.

10 Q Yes, but you say you have not done the detailed work on that, that is not something you
11 would automatically say is wrong?

12 A No, I wouldn't, I don't know that I'm in a position to say it's wrong, because it's really a
13 matter of policy and possibly law. What I can say is as a matter of economics it may or
14 may not be wrong, and what conclusion you come to may depend on the welfare
15 considerations as well.

16 Q Your case essentially is not that that is a wrong policy preference, or there is not a market
17 value but that Ofcom was addressing it in the wrong way in trying to do some determination
18 of prices to remedy it? Is that fair at a very general level?

19 A I think that's very fair, no I think that's exactly right. I'm not sure that there's a huge
20 dispute between us in terms of: what would you do if there was a problem? The question is:
21 what are your obligations and how is the best way to go about it? I think that is where the
22 difference is.

23 Q Can I come on to cost oriented pricing and departures from cost oriented pricing? You do
24 not contend, as I understand your report, that regulators are obliged, as a general
25 proposition, to follow cost oriented pricing in setting interconnection prices, or taking
26 decisions which may have an effect on interconnection prices. As I understand it, your
27 position is that there are good reasons for regulators departing from cost-oriented pricing in
28 limited circumstances. Is that fair?

29 A My position, without taking a view on the law is, that there are some obligations to at least
30 consider it, but put that aside, as an economist what I am saying here is my experience is
31 that cost-orientation, cost-based calculation the bedrock of most forms of interconnection
32 and that that is an economically defensible start point, certainly the normal start point, I
33 agree with that.

1 Q At para. 17 of your first statement you set out four conditions which you say justify a
2 departure from cost based pricing?

3 A Yes.

4 Q Or would be needed to justify it?

5 A Yes.

6 Q I would quite like to look at the conditions and go through them:

- 7 "a. There are two separate customer groups on the platform.
- 8 b. That customers groups have a demand based interrelationship such that there
9 are significant 'externalities' between the groups ...
- 10 c. There is no direct relationship between the two customer groups that allows
11 them to 'internalise' the externalities.
- 12 d. Lack of a direct relationship creates what is in effect a fourth requirement, that
13 the platform operator is best placed to balance the demand inter-relationship by
14 adjusting relative pricing to each customer group."

15 As I understand it, from what you go on to say in para.23 about telecommunications
16 networks generally, you would accept that conditions (a) to (c) are satisfied for NTS calls,
17 among others. Is that right, at para.23 you talk about telecommunications networks
18 generally, and then you go through (a), (b) and (c).

19 A Actually, yes. I think where I'm coming from is that I don't there's any great dispute that
20 telecommunications networks are one of the big examples of two sided networks that are
21 usually bandied around when people talk about these things.

22 Q Markets?

23 A Yes, telecommunications markets. I think it is agreed, and I think it's agreed between the
24 experts that they're a two sided market, so there's no dispute there. The point I'm making
25 is that that is actually normal in telecommunications market, and we still normally use cost
26 orientation. So the question is, when should we depart from that? The newspaper example
27 is fairly standard story that gets rolled out along with nightclubs, but the reason that I use it
28 as a relatively easy to understand example of why we are concerned about this. We're
29 concerned about this because in a two sided market where there are two consumer groups
30 with different elasticities of demand, you may need to use demand based pricing to create
31 efficient outcomes. The free newspaper is a good example. I think we all accept now that
32 that is an efficient and a good thing in society, but cost based tools don't work there,
33 because it can be efficient to have the consumer pay nothing for the newspaper and
34 advertisers to pay all. So that's the question. The question is, there are lots of two sided

1 markets. Telecoms markets are two sided. Though normally you costs, when do we
2 depart? My view is that when you go down this list – we can debate them extensively – the
3 NTS platform, if anything, is a case where there are departures from these conditions such
4 that you wouldn't get away from costs based pricing as a start point.

5 Q Can we look at (b) for a moment. You use the example, as you said, the newspaper
6 example. It is the case, is it not, that just as advertisers benefit from low newspaper cover
7 price which improves circulation, so here in this case SPs benefit from a retail price for 08
8 calls which is, one, low, and two, clear, transparent. You would accept?

9 A Yes, that's true, but that is exactly the same as in any normal vertical supply chain.

10 Q I have not suggested it is any different, I am just taking it stage by stage. At that stage of
11 the analysis it is right, is it not, that they benefit ----

12 A Yes, that's so, and also it's equivalent to any case where there is a retail pricing problem.

13 Q What I would suggest to you is that there are two problems in particular in this market. The
14 first, which Ofcom have particularly averted to, is what is labelled the "vertical externality",
15 that there is no clear incentive for OCPs to take into account the effect on service providers
16 when setting 08 retail prices. In other words, OCPs may not have an incentive not to mark
17 up prices excessively harming service providers. First of all, do you accept that that is a
18 consideration you took into account?

19 A I do. I think there is no dispute between us at all.

20 Q You accept that it is a problem, do you not, in, I think, para.51 of your third statement. You
21 accept that that is a relevant externality in this market?

22 A I don't have a view on whether Ofcom's concerns are right and wrong. But on a point of
23 principle, I accept that, yes, it can be a concern and it is a valid externality.

24 Q Would you not go further and accept that this is actually a relevant externality in this market
25 – in other words, an actual problem? It is the case, is it not, that OCPs do not have SPs'
26 interests in that way?

27 A Yes, that's true, in the sense that's true for any retailer. Do I hold the view that it's
28 definitely a problem? I think my general view is I'm undecided until there is a full review,
29 or I'm involved in a full review of the 08 platform. I don't dispute that Ofcom has these
30 concerns. I don't disagree with that.

31 Q We start off with the position where there are high retail prices, on the face of it
32 considerably higher retail prices that can be justified by costs of origination and termination.
33 Ofcom is clearly concerned, and I would suggest to you reasonably and rightly concerned,

1 about the externalities that may plausibly account for the high retail prices. The vertical
2 externality is, itself, a strong explanation for at least part of that phenomenon.

3 A Yes, there's no dispute about that. I think the issue is, I am agreed, that Ofcom is
4 concerned, and there may be good reasons for them to have that concern. The issue is how
5 do you go about dealing with that. Really the basis for my statement is that I've been
6 through this exact issue a couple of times in the UK in 2003 and 2009 arguing for the
7 MNOs that an almost identical vertical externality existed fixed to mobile calling where
8 mobile termination rates were being regulated down due to a series of detriments, and one
9 of the problems, or at least from our perspective one of the problems was that as the
10 termination rate goes down the wholesale rate reduces, the fixed networks do not fully pass
11 that through to consumers and hence the detriment is not removed. So the question is, how
12 do you deal with that? My experience is that Oftel, Ofcom and the CC took those concerns
13 on board, and if you go back to the references which are in my reports, you will find that
14 they deal with the point very briefly indeed in a couple of paragraphs, and that is because
15 their response is essentially it's pretty much a no-brainer, that's a retail market issue, we are
16 setting wholesale prices, we set wholesale prices at cost, we get that right and then if there
17 is a retail market problem we will look at that market in due course with the relevant tools
18 and fix that problem.

19 Q In other words, and this is really what you say in para.51 of your third statement, you are
20 not only not denying the problem, but you are not denying Ofcom's appreciation of the size
21 of the problem. What you are saying is the regulatory remedy should lie on the side of the
22 market where the problem is, namely the retail side. This is a matter for retail regulation?

23 A Yes, I am, and I do believe that there are sound economic reasons for the way that those
24 things are usually broken up into markets.

25 Q The second potential externality which Ofcom is concerned about is the horizontal
26 externality. OCPs may not have incentives to take full account of the effect of their
27 decisions on consumer price awareness. It is, as it were, the brand issue that has been
28 referred to the Tribunal. In particular, there is the danger of damaging or destroying the link
29 with geographic prices of the number ranges. Would you accept that that is also a genuine,
30 albeit you think Ofcom's reaction to it is the wrong reaction in regulatory terms?

31 A I absolutely accept that that is a valid concern, there's no dispute about that at all. I would
32 make the point, however, that the fixed to mobile disputes that we're talking, there were
33 horizontal externalities involved as well, and they were actually remarkably similar. They
34 come about because there's also a lot of uncertainty amongst consumers about the costs of

1 calling a mobile phone and they act of perceived prices which are far above actual prices,
2 and for very similar reasons to what we are talking about here, particularly the smaller
3 networks – it’s not BT, not the bigger networks that are the biggest offenders, but the small
4 networks with this unawareness were actually the worse for not passing on changes and the
5 wholesale termination rates. So there were horizontal externalities there as well, which
6 seemed to have a free-riding effect by small fixed operators.

7 Q Do you also accept – and I will come on in a moment to the question of how Ofcom ought
8 to deal with it, if at all – can I take you shortly to what the NGCS said in relation to these
9 externalities just to see if you have any disagreement with that. Can I take you to bundle
10 13, tab 3.1, which is the NGCS consultation report, and I will take you to para.4.23, please.
11 This is dealing, first, with a problem of over-estimation. We suggest there is powerful
12 evidence of over-estimation:

13 “Not only are consumers generally uncertain of NGC retail prices, many tend to
14 overestimate non-geographic prices.”

15 Then examples are given in the rest of that paragraph. You would accept, would you, that
16 this evidence give substance to the concern about externalities?

17 A I should make clear that I have not worked on this particular document, and I am not
18 familiar with it, but I would not dispute it. I would note that this sort of data and these sorts
19 of effects are very similar to what I have seen in other markets, so it’s quite a problem of
20 consumers not knowing what the call costs and therefore over-estimating to protect
21 themselves.

22 Q Thank you, and just very shortly, there is also a problem, is not there, which perhaps is well
23 summarised at 4.49, if I could ask you to go forward to p.53. There is evidence, is there
24 not, that consumers pay very little attention to the pricing of 08 calls generally, they are not
25 the focus of competition, for example, in choosing a mobile provider or a mobile package,
26 and you can see that dealt with in the second bullet point on 4.49:

27 “Callers do not regard the price of non-geographic calls as important when
28 selecting a telephony provider. In the Ofcom consumer research”

29 and, again figures there. We are not going into particularly detailed figures. Would you
30 again accept that?

31 A I don’t see any reason to dispute that evidence. I’m not so clear on what one might
32 conclude from it. I think there’s two things that come out of that, that if consumers are not
33 overly concerned about the cost of 08 calls in their mobile packages, then their mobile
34 operator’s response is essentially a Ramsay pricing response, and it may be efficient if you

1 put aside the horizontal externalities across the platform as a whole. So, that is one point.
2 The other point I would make, and I haven't been through the detail of this so I don't know,
3 but, at the end of the day the other reason that consumers may not be overly concerned is
4 that most of them have the option of picking up their fixed phone somewhere close by,
5 particularly for 08 calls, so it may not be of great concern.

6 Q Those are potentially ameliorating effects to the extent that you have substitution —

7 A Yes.

8 Q But the reason I take you through this, although obviously you are not disagreeing with it, is
9 because this is crucial is it not? This is why Ofcom considered that the NTS market was
10 relevantly different from the market for geographicals. Because these particular
11 externalities and problems that we have been looking at are externalities that are not
12 applicable in the normal geographical market.

13 A There is no dispute over that at all. The purpose of my statement was to make clear that, in
14 my view, and I think it's not essentially in dispute now with Mr. Myers, that these are retail
15 market issues. Now, the reason I did that was, when I was pulled in at the first stage to
16 make my first statement was, if you go back through the documents and look at Myers 1, it
17 starts out with "The key issue. two-sided market", actually the key issue is not a two-sided
18 market, the key issue is a vertical externality in the retail market. That was the purpose of
19 my statement, it was simply to restructure the nature of the debate. Now, why should the
20 Tribunal care about that? I think the main reason is because of the way that the policy
21 process generally works is, it is actually quite important. It is important potentially,
22 possibly legally and procedurally, but it is important intellectually, so that we know what
23 we are dealing with, and I provided the examples that actually Ofcom themselves have
24 summarised in NCCN500, where they looked at a number of decisions by the OFT and the
25 CC, where there were two-sided markets and — and generally being very careful to unpack
26 the two-sided market. Are we talking about a one-sided problem, and shall we deal with it
27 in that market, or are we talking about a fundamental need to change the wholesale pricing
28 on the platform itself? So, the sole purpose was to actually just change the nature of the
29 debate slightly and point to where the problem is, and that's for the Tribunal to decide
30 where that takes them.

31 Q Yes, and that is very helpful because Mr. Myers might disagree that it was ever a proper
32 interpretation of the final determination or of his evidence, that simple fact of two-sided
33 markets was being relied on, but that may be a matter of unnecessary archaeology. The fact
34 is that your first report dealt at some length with the fact that the NTS market was a no more

1 two-sided market than the geographic call market but that is all slightly water under the
2 bridge because, as you say, it is effectively common ground that the reasons for Ofcom
3 treating this market in the way it has are much more specific than that. They relate to these
4 externalities that I have been putting to you.

5 A I think it is common ground, as I understand it, with Ofcom, I think Dr. Maldoom may
6 have —

7 Q Yes. There may be others who would disagree.

8 A But, I think it is common ground.

9 Q Indeed. And Ofcom's view that there is a serious market failure in this situation arises from
10 those same reasons. Can I go back just, then, to your para.17 reasons, conditions, rather,
11 for, and look at condition C which we are coming on to. There is no direct relationship
12 between two customer groups that allows them to internalise the externalities.

13 Now, there has been some evidence in this case of some arrangement which could be seen
14 as internalising externalities, for example DWP help line.

15 A Indeed.

16 Q I do not know whether you have been in court or read the transcripts to date relating to that.
17 You know what I mean about the DWP help line issue?

18 A Yes, that's correct, and there's various pieces of evidence about cases where there may be
19 internalisation.

20 Q You are not suggesting, are you, that the externality problems Ofcom apprehended and were
21 the reasons for its action can effectively be disregarded because those externalities can
22 generally be internalised, are you?

23 A No. My argument is considerably more fundamental, actually, to be honest.

24 Q Yes.

25 A The telecoms networks are two-sided markets, and I think there's been testimony taking you
26 through that it works on a "calling party pays" principle as the standard, and that's really
27 standard internationally. The calling party pays system has the potential for calling
28 externalities when actually the calling party isn't the one that really wants to pay or isn't
29 willing to pay. So, there are potential inefficiencies. So, what do you do about that?

30 I think one of the things that's missing is the NTS platform is really a commercial platform,
31 it's an economic beast that sits on top of the fixed mobile networks. Its function is to allow
32 the service provider to internalise externalities, so its function is to provide the service
33 provider with a selection of call charging options right through from "I pay everything" to
34 "You pay everything" through to "You pay some more". That is its function. And although

1 it might seem slight perverse, this is why the NTS platform is the last place I would go
2 away from cost based pricing, because it is a service provider that decides who pays what,
3 what the service provider needs is correct costs based signals out of the platform, it's more
4 akin to a logistics platform than a standard calling party pays, so, you know, a logistics
5 platform, a tracking firm, it's the same, it's got customers on at the side, they internalise by
6 one of the customers or both of them negotiating and deciding the price. In this case it's the
7 SP that has the information. So, the platform itself relies on costs based pricing, and
8 Ofcom's analysts and economists and the NCCN 500 identified this, and I have some
9 quotes from the NCCN 500 in my third report where they go through this, and they work
10 through this and figure out that, well, really it's what they might call, they call it, I think, a
11 single-sided platform market, ie you want to see costs based prices. And so in the context
12 of NCCN 500 one of the reasons they choose to define the market the way they do, is it is
13 specifically not their case, it is specifically not dealing with the balance of prices across the
14 platform, and they do that partially because the two-sided nature is fixed by regulation.
15 And so their case was not akin to this case; and my case is actually quite fundamental that
16 the NCCN 500 is correct when you read deeply into it. The NTS platform itself should
17 operate off cost. I don't dispute Ofcom's concerns on the vertical, on the retail site, but my
18 view is that you should deal with their problem in their market.

19 Q Now, I want to take this stage by stage, so I am going to resist the urge to jump in on that.
20 I want to just focus still on, as it were, the pressure valve of internalising the externalities.
21 You would accept that, as it were — would you accept, first of all, that the service provider
22 is not necessarily best placed to optimise the relationship because the problem arises from
23 the behaviour of the OCP in terms of retail pricing, within the SP generally has no direct
24 relationship.

25 A That's correct, it's similar to many retail/wholesale markets.

26 Q And you might have some ways, in particular circumstances, of getting around that, for
27 example where you have an SP which is large enough, like government, for example, and
28 which potentially is not profit conscious in the way a commercial body would, that it can in
29 fact have a particular arrangement with the MNOs. But that is not typically the route by
30 which one could internalise the externalities.

31 A That's true. Not every SP is going to be able to do that, although I do know that there are
32 aggregators in the market who might be better placed to do that for small SPs, but —

33 Q Yes, but are you aware of any arrangements of that nature in relation to 0845 or 0870 calls?

34 A I think not, no. Not to my knowledge.

1 Q Not to Ofcom's either. Can I come back, then to your conditions, and perhaps to condition
2 "d", which I think you are suggesting is perhaps where the real issue lies. The condition
3 here is the lack of a direct relationship creates what is in effect a fourth requirement, the
4 platform operators best placed to balance demand interrelationship by adjusting relative
5 pricing to each customer group. Your objections, as I understand it, to the wholesale tariff
6 schedule is, as you say, I think, at para. 22, the platform operators' solution may not be the
7 socially optimal solution that a regulator would use if it were able to do so. I think the way
8 you put it towards the end of para. 22:

9 "... in the context of intervention by a regulator it is important to note that the
10 platform operator's solution may not be the same as or even close to the socially
11 optimal solution that a regulator would choose if it were able to do so. Where the
12 platform operator has market power in respect of one or more sides of the market,
13 the platform operator can be expected to set prices so as to maximise its own
14 profitability at the expense of reducing demand below optimal levels."

15 Are you not effectively asking here, in your condition d. whether the NCCNs are the best
16 option, not whether they would be better for the *status quo* than the *status quo* for
17 consumers and competition. Is that not the effect of your fourth condition?

18 A What my fourth condition really was about was the general question of when do you have
19 cost based prices? When is your cost guideline the way to go, so to speak, and when do you
20 go away from that? This really is talking about whether or not the platform operator is in a
21 good position to optimise the platform so the newspaper example I gave was a relatively
22 simple one. It is the newspaper owner that knows how much they should charge
23 advertisers, and how much they should pay consumers. I think in terms of the proceedings
24 that Ofcom finds itself – and actually the fourth condition is often in the hands of the
25 regulator, so it's the regulator that is optimising.

26 Q Yes.

27 A In terms of what I think you are asking me, the question I think you are asking me, is am I
28 saying that it's absolutely necessary for BT to optimise, I don't mean that to be the case,
29 and I think somewhere towards the end of my statement – what did I say? Paragraph 35: I
30 say:

31 "... providing greater net benefits to consumers in the long run, it too would have
32 to engage ..."

33 So I am not arguing that BT or Ofcom would necessarily have to optimise.

1 Q But what you are arguing, I think, certainly in para. 26 of your first statement, and then in a
2 large part of your third statement you are focusing on explaining why regulation in the retail
3 sector would be a preferable way of addressing the problem with the MNOs retail prices?

4 A If there was ultimately found to be a problem and there were the correct tools then I think
5 that's right. I think one of the issues that we have here, what we short cut here is the whole
6 issue of what are the problems really? I know Ofcom has had many problems, there has
7 been a number of investigations over the years but there is still quite a bit of uncertainty
8 really about where they might come out at the end of the policy process they're in at the
9 moment. So we have jumped to the conclusion that there is a problem.

10 Q Well we have not entirely jumped, I put to you before we got to this stage, I put to you the
11 externalities, and the nature of the externalities, and the extent of the externalities as Ofcom
12 sees it and what I am now focusing on is your response, which is perhaps summarised at
13 para.26 of your first statement:

14 "… the best approach is to directly deal with the market failure in the relevant
15 market rather than through adjustment to wholesale interconnection rates."

16 Now, of course, Ofcom may not disagree with you of course, as you know Ofcom is
17 engaged in the NGS review, but I would suggest to you that that is not the relevant question.
18 This may be a matter of law, but let me put the point to you in case you want to comment.
19 Ofcom effectively is faced with a dispute resolution role in this case, or was faced with that,
20 and the standard that you are setting is effectively one which is focusing on the best solution
21 to deal with the problem rather than focusing on what Ofcom had to deal with in this case?

22 A Right. I think it's clear that ultimately exactly what Ofcom is required to do was a question
23 of law. The purpose of my statement really was twofold. One was to raise the issue of the
24 two-sided platform that in my view that really was not the core issue that was driving all
25 this, and the second issue really was to look at problems with similar economic structures
26 that have been dealt with by the UK regulators and telecoms' markets and bring those to the
27 attention of the Tribunal as to how they dealt with this problem. So that was the function of
28 it. I fully accept that as a matter of law Ofcom might have to do different things in a dispute
29 resolution.

30 Q I am certainly not trying to take you into areas you are not covering. Let me move on to a
31 slightly different subject, which is the principle of revenue share and how that features in
32 the decision. Just dealing generally first – we know that there obviously here a variety of
33 information services being provided over the telephone, a whole range of different services,

1 some of these services are ones where the callers are willing to pay the service provider for
2 the information, are they not?

3 A Yes, particularly 09 type services, yes.

4 Q It may be very convenient for callers and for service providers for those services to be paid
5 for via a micropayment system that has been referred to, micropayment mechanism through
6 the telephone system rather than, for example, making a credit card payment or something?

7 A Yes, that may well be the case, particularly for 09 and for some other number ranges.

8 Q It is also to some extent the case for 0845 at the moment, regulatory supported by 0845?

9 A Yes, although I think there is quite an important factual question here. My view is that the
10 revenue share function is a bit of a red herring on the mobile network, because really Ofcom
11 has a policy preference that there is no revenue share on an 0870. 0845 that's right I
12 understand that there is still revenue sharing. As best as I have been able to find out from
13 public documents, it appears that most of that revenue sharing is what's called 'dial-up
14 internet ISP activity' it's the old fashioned modem, and it goes 'beep, beep, beep, beep'.

15 Q A dying market?

16 A That's right, a dying market. The issue with that is that this doesn't happen for a mobile
17 phone, so I think that's just a factual question. It's not at all clear to me that there is a
18 significant amount of revenue share left on 0845 calls from mobiles.

19 Q Whether or not there is revenue share there are two aspects of that question, one is as to
20 whether it is actually regulatory supported as it used to be for 0845 and 0870 and still is for
21 0845 to an extent, subject to the reservations you have mentioned, but it is perfectly
22 possible for revenue sharing to arise in any event, even if not particularly revenue
23 supported, if the charging structure is right, and if moneys are, in fact passed through and
24 that is very much what we are looking at in this case?

25 A Yes, it is the case, and actually that is one of my concerns with this case and the way it is
26 proceeding at the moment. Revenue sharing can happen inadvertently and often it can have
27 unintended consequences which are not necessarily good for consumers and, indeed,
28 arbitrage concerns one of the major issues that drive regulators towards cost basis and cost
29 base ... is to close off arbitrage and unexpected outcomes at least on one side of the market.
30 So it is correct that there can be unintended revenue sharing. I think there are proceedings
31 before the CAT at the moment, the *Stour Marine* case, for example, where in my view
32 that's exactly what's happening with mobile termination rates. My view would be that form
33 of unintended revenue sharing is often an inefficiency, and I wouldn't consider identifying
34 that it occurs ----

1 Q It may not necessarily be unintended. There is a gap, is there not, between having express
2 regulatory support through cost origination charges being limited or whatever, or
3 termination charges, and it being unintended. What is not the case here, is it, is that Ofcom,
4 as it were, let it through without looking at it. It was examined quite carefully in the final
5 determination, was it not? I want to come on with you to look at the specific treatment of
6 revenue share in the final determination. Maybe in asking the general question I should
7 actually put to you Ofcom's reasoning. But just before we get there, it is right, is it not, that
8 if, just dealing with the mechanism first, rather than the rights and wrongs of revenue share,
9 it is obviously the case that if money is to pass through the TCP and get to the service
10 provider, then the gross payment received by the TCP from the OCP has to exceed the
11 TCP's own termination costs?

12 A Yes, absolutely.

13 Q So effectively one can see that if one wants, as a departure from cost based termination.
14 But alternatively one can view the money that is going on to the SP has not been part of the
15 termination charge at all, or at least not been part of the net termination charge. I do not
16 think anything is going to particularly turn on the taxonomy of it, but one can distinguish
17 between gross and net termination charges, can one not?

18 A Yes, one can. I'd have to say that I see the revenue share argument being put forward as a
19 cost that has gone and disappeared and I do struggle a little bit with that, and the reason for
20 that is that my view is that the NTU system is under pressure for a whole range of reasons
21 but still where we are today, the position we have today is related to the star point, and the
22 star point of the system was that it was anchored into fixed network prices from BT, 0845
23 and 0870 are supposedly national rate calls. I take the point the revenue share that exists
24 and it's done by subtraction, but I don't think when you have something that's based on to a
25 local call that cost has disappeared altogether because the maximum possible revenue share
26 is the cost of a local call, and you would need a very strong reason to consider going beyond
27 that. I still think there is some cost basis in the broad ----

28 Q Certainly that is not in these proposals, I think that would be accepted, it is not in any sense
29 based on cost. Can I look with you at how Ofcom dealt with the cost of termination and the
30 revenue share issue. First of all, it is right, is it not, that Ofcom did look at BT's cost of
31 termination in the 0870 final determination?

32 A I don't dispute that.

33 Q It used a proxy, it used the 0870 determination?

34 A Yes.

1 Q Indeed it was invited to do that by the parties instructing you?

2 A Yes.

3 Q I do not think I need turn it up, that is para.4.45 of the 0870 final determination. It started
4 there. The three principles then took into account the potential effect of revenue share, did
5 they not?

6 A Yes.

7 Q Of course, before one gets to revenue share there was one scenario on which this problem
8 simply would not exist at all. In the full reduction scenario, if BT was right and the MNOs
9 are going to be incentivised to bring their prices down to the lowest step then there would
10 be no additional termination charge at all. That is right, is it not?

11 A That's right, and I think between Ofcom and BT they are agreed that that would have been
12 satisfactory for Ofcom.

13 Q Yes, that would have been net welfare beneficial. There is certainly no dispute as far as
14 Ofcom is concerned. The point for present purposes is that the whole revenue share
15 discussion does not take place, if that scenario is right, because there simply will not be any
16 pass-through and costs will be just as termination based as they are at present?

17 A That's correct, yes.

18 Q And no one is suggesting in these proceedings, certainly not on this appeal, that Ofcom
19 should have gone further and investigated the costs based nature of the existing charge?

20 A I don't think so, no, that's correct.

21 Q Of course, revenue share becomes an issue if prices do not fall to the lowest step. Ofcom
22 rightly identified, therefore, revenue share as one of the potential roles or consequences of
23 the termination charge in that situation – para.4.7 of the final determination. I think, again,
24 you accept that, that is a non-controversial step, I think. He has identified it as a relevant
25 feature and it was discussed as a key issue to be assessed under Principle 2 and the welfare
26 analysis?

27 A Yes, I agree with that. The only caveat I make, and it is not really a caveat as such. I'm
28 aware that Ofcom considered whether it should so call increase revenue share. I think that's
29 slightly odd, and my understanding is that the policy preference, if you want to call it that,
30 at the time was that revenue share should not be on 0870 any more; and, if I understand it
31 correctly, on 0845, since about 2005/2006, the position was that it would be phased out.
32 I'm not disputing you.

33 Q Did you say that Ofcom favoured an increase in the revenue share?

1 A No, no, I'm sorry, on 0845 and 70 that it had essentially been decided it should be phased
2 out and 0845 would die out with dial-up buyers' fees. So the only point I would make is to
3 look in a contract dispute resolution process at increasing revenue share when the general
4 policy seems to be towards reducing it on those numbers struck me as a little bit unusual.

5 Q I am just going to focus for now on, as it were, the mechanism by which Ofcom dealt with
6 revenue share just to ensure that you have no disagreement with that. Ofcom effectively
7 looked at what was going to happen to the revenue share monies in its welfare analysis. It
8 considered whether, if they were paid to the termination provider, they would then be
9 passed through to the service provider, whether that was likely, and further, whether they
10 would then be passed through from the service provider to the caller. That is right, is it not?

11 A As I understand it, but it's not an area that I've gone into in any depth.

12 Q It treated monies that were passed all the way through to the caller as counting in the
13 welfare analysis, as it were, at full level. It valued the benefits attributable to that, did it not,
14 in the analysis?

15 A To be honest with you, I haven't dug in depth into the analysis so I wouldn't want to put my
16 stamp on exactly how they weighted it. There seems to be considerable dispute over that.

17 Q Ofcom did not, in its analysis, particularly favour revenue share, did it? It did not endorse it
18 as a positive good in its analysis, did it?

19 A Again, I'm not that close to the detail. I had understood that it at least considered revenue
20 share going to the service providers as being a positive thing, and I may be mistaken about
21 that.

22 Q There are two ways of putting that. Ofcom had a policy preference in relation to
23 rebalancing between 08 calls and other mobile calls. It gave expression to that policy
24 preference by placing greater weight on the direct effect, did it not. It had an inbuilt bias in
25 its model to favouring that policy outcome, did it not?

26 A Yes, I certainly understand that to be the case.

27 Q But it did not have a similar bias or policy approval or anything inbuilt into the model to
28 support revenue share. For example, it did not weight the indirect effect more strongly than
29 it did the counterbalancing mobile tariff package effect?

30 A I can't comment on how they weighted it because I'm just not that close to the analysis, to
31 be absolutely honest with you. I'm not disputing it.

32 Q Certainly I suggest to you that is the case. If that is right then all Ofcom did was effectively
33 look at revenue share as a facet of what would happen if the termination charges did not

1 reduce to the lowest step and took account of the consequences, but it did not place any
2 regulatory approval or extra accounting on that consequence?

3 A Not that I'm aware of. The only real view I have on this is that, in my view, Ofcom should
4 have been quite wary of increased revenue share, particularly given its concerns, and the
5 reason for that is that I think there's been quite a lot of discussion and debate about whether
6 or not NCCNs would lower the price fully and there would be no increase in revenue share
7 or whatever. If you get an interim outcome, then the problem is that consumers may not be
8 all that more knowledgeable. In fact, they may not be any more knowledgeable at all. You
9 may have the same issues on the retail side of the market. My concern is that if you
10 increase the revenue share on the SP side of the market, you may create a rent-seeking
11 opportunity. You may incentivise SPs to use 0845 and 70 numbers when they wouldn't
12 otherwise have done so, because they're getting paid to do it. If you haven't fixed the
13 problem on the retail side then you actually exacerbate the whole situation. In terms of my
14 understanding, the main thought that I had on the SP side is I would be actually quite wary
15 of giving a positive weighting.

16 Q I suggest to you that Ofcom was wary of revenue share in precisely the way that you are
17 suggesting. In the first place, it did not value monies that remained with BT at all. Perhaps
18 more relevantly, if there was relevant share and the monies went to the service provider, to
19 the extent that Ofcom was not satisfied that the monies would go on to caller benefits it
20 placed much less weight on the monies held by the SP. Is that not a precise expression of
21 the wariness that you are indicating?

22 A If that's the case then I think I would agree with that position by Ofcom.

23 Q Of course, BT complained about Ofcom's reasoning in that respect, but Ofcom clearly in
24 the final determination placed less weight on flow of monies through to the SP and of
25 course that is in no small part what caused Ofcom to reject the NCCNs and to reach the
26 conclusion that your client was seeking?

27 A Yes, and I don't disagree with Ofcom's overall conclusion at all. The issue is whether or
28 not there was a better way to proceed through this inquiry and in some sense how much
29 effort is going to be expended on contract dispute resolution processes if we have a free
30 form analysis of contracts of this style.

31 Q It was not only that Ofcom was concerned about monies remaining with the SPs. On the
32 other side of the equation, Ofcom also in its reasoning noted the points that you have made
33 about the potential limited effect in ameliorating the externalities if you had only a partial
34 fall of prices – in other words, that there would still potentially be price confusion and there

1 would still potentially be lack of visibility, lack of clarity. So the improvement in welfare
2 from brand awareness or indeed volume increases might be very limited?

3 A Yes, that's right, and I don't think there's any great dispute honestly. I think the only point
4 I would make is that at the end of the day this is why cost is the usual benchmark in
5 interconnect proceedings because it closes off problems on one end of the equation, if you
6 like, and when you're dealing with uncertainty all over the market and on both ends it can
7 be a better world if you're fairly confident that one end of the equation is correct and then
8 you've limited the problems to the other end and you deal with those when you can, but I'm
9 not in dispute overall with Ofcom's conclusions.

10 Q It sounds from what you are saying that there is very little space between you and Ofcom at
11 all. You had a regulatory preference for retail regulation, but in the situation in which
12 Ofcom found itself you accept that Ofcom was wary in relation to revenue passed through
13 as you have suggested. Indeed, Ofcom did not merely check that monies were leaving BT
14 and going to the service provider and therefore BT was only being left with a cost-based
15 amount. It went further than that in examining what weight to give to the money in the
16 hands of the SP and indeed looking at how much money would go through to the caller. So,
17 in a sense, it was going beyond checking that BT was only left with a cost based amount?

18 A That might be, and there's not that much difference between us. However, I think the one
19 issue I should signal quite clearly is that Ofcom has its retail policy preference. One of my
20 concerns about this procedure is that Ofcom may decide within the next 12 months or so,
21 that their policy preference should be changed to something else after it's finished a
22 complete investigation.

23 Q Yes.

24 A And consideration of what it really can and can't do, and how to deal with the platform as a
25 whole and not just individual numbers. So, my concern is that a policy preference which
26 may be incorrect is being taken into account. In this case Ofcom has denied the proposals,
27 but if it had accepted the proposals, if this procedure and approach is correct, then you may
28 be building in things that we change in the near future.

29 Q Would it be fair to say that your concern could be dealt with by Ofcom on a future occasion,
30 or indeed the Tribunal on this occasion, being extremely wary and cautious when assessing
31 the consumer welfare of such a proposal — needing to be satisfied that the proposal was
32 clearly and truly welfare beneficial before endorsing such a change?

33 A I guess you could say that. I think my position is that, my concern is that a dispute
34 resolution process is not really, I mean, as I understand it, it is not really a suitable forum

1 for doing this sort of thing. One of the mistakes that I believe has been made is that Ofcom,
2 for a dispute resolution process, uses a lot off the shelf information and that is completely
3 appropriate when you're dealing with a sure fire procedure. However, the information that
4 was taken off the shelf was NCCN 500 market definition in various parts of it. I think they
5 misunderstood what NCCN 500 had actually done and whether or not it was applicable to
6 this dispute resolution: for example, the market definition used in NCCN 500 did not
7 consider the issue of OCP to TCP platform and whether it should be considered as one, it
8 considered that TCP hosting role and the termination of the geographical call. So I think
9 that an error was made under pressure of time, where the analysts probably did not take a lot
10 of time to read many hundreds of pages and really understand what it was. So, the point
11 there is not so much to criticise Ofcom, the point is that a dispute resolution process is a
12 four month process. If I was asked in Ofcom, or I was, you know, on the team and asked to
13 review the market definition thoroughly, I might need a couple of months to do that alone.
14 So, my concern, really, is the inefficiencies that arise and the increased possibility of error,
15 of undertaking what amounts to a fairly fundamental policy review in a short period of
16 enquiry.

17 Q Yes, I think that those behind me would probably agree with much of the general concerns
18 that you have as to the difficulties of conducting the sort of process in this decision. But is
19 not the answer to that Mr. Muysert, not to, as it were, throw up one's hands and say, "We
20 can't do it at all, we will leave it to a policy review". The answer is to adopt something not
21 perhaps so far from precautionary principle to require that there must be a clear benefit
22 demonstrated by the proposed change before it should be allowed to go ahead or should be
23 approved, because of the uncertainties, because of the problems in bottoming out, the
24 myriad of factual questions and the many boxes on the forms we have looked at, if one is
25 going to quantify it, one would need to be satisfied that it was not consumer detrimental
26 before approving any proposal.

27 A That's an entirely reasonable statement, but I actually disagree with it; and the reason that
28 I disagree is that, if you stand back a little from the whole problem, the European regulatory
29 framework works on the principle that where possible you de-regulate and you pull
30 regulators out of the market. The reason that the system works that way, I believe, the
31 underlying economics is that errors occur. It is very difficult to get decisions right all the
32 time. We actually have quite a poor understanding of some markets, look at the debate over
33 is there a waterbed or is there not a waterbed? It's a fairly simple question, but we don't
34 really know it. So, it's quite easy to make mistakes. Those mistakes are costly, and they

1 tend to be more costly in the long run, so there are dynamic concerns. And the policy
2 response to that is to limit regulation to major problems in markets where there is market
3 power and then to overlay various other consumer protection procedures as well. So how
4 does that relate to your question? What that says to me is that it is accepted that it is very
5 hard to get decisions right on the fly. So, although what you say sounds reasonable, we will
6 try our best to make a good decision, the general principle of the framework is that actually,
7 we're going to get those decisions wrong reasonably often, and if we make policy on the
8 basis of them, then they will be locked into the system. And that, I think, is precisely why
9 Oftel and Ofcom and CC batted away our concerns of the vertical externality in the fixed
10 mobile market for exactly those reasons. They didn't want to go into a long-winded
11 investigation, make a bad decision and then build a Band-Aid repair into the connection
12 between two major markets that is still here after they might have fixed the problem
13 elsewhere. So, I hear what you're saying, and it sounds quite reasonable, I actually think
14 there's a need for discipline and to accept you can't fix all things all the time, and
15 particularly not in the short term.

16 Q I think we may have reached the stage of a legal question rather than a policy one, so I will
17 leave it there.

18 A Yes.

19 Q Thank you. I have no further questions.

20 THE CHAIRMAN: Thank you very much, Mr. Herberg. Shall we resume after the short
21 adjournment. And shall we say five to two.

22 (Adjourned for a short time)

23 THE CHAIRMAN: Miss Lee.

24 Cross-examined by Miss LEE

25 MISS LEE: Good afternoon, Mr. Muysart.

26 A Good afternoon.

27 Q Could I ask you to take bundle C2, please, and turn up your third witness statement which is
28 at tab.38, and turn to para.10 which is at p.5.

29 A Yes.

30 Q The background to the comments you are making in para.10, I think, are the points set out
31 in para.8, and in particular I wanted to focus on the point at para.8.2, where you set out the
32 point made by Mr. Myers where he says (at b):

1 “The model of competition and the nature of the regulatory concerns are distinct,
2 with competition focused on ... retail pricing by OCPs in the case of non-
3 geographic calls”,

4 means that there is a difference, in effect. And then, looking at your para.10, you say that
5 you do not consider that they are, the differences are as great as Mr. Myers suggests, and in
6 the second sentence:

7 “One of the major reasons for this is that in my view the NTS system is a value
8 added service on the core fixed and mobile networks rather than a standalone
9 platform. It follows that many of the attributes of the economic system (such as
10 the nature of OCP competition and the regulation of termination) are the same”,

11 And then you go on to explain that a little further. But I think you said this morning that
12 you did not hold a view, really, about the nature of competition in the OCP market. Is that
13 correct?

14 A No, I think what I, I hope what I said, was that I didn't hold a view on whether Ofcom's
15 concerns as to regards the pricing of 08 numbers and other NTS calls as a valid concern or
16 not. I haven't investigated that. I don't think that I was meaning that I don't have a view on
17 OCP competition in the mobile market.

18 Q So would you agree, there have been various comments made by Professor Valletti in his
19 statement, and I think you may have heard Dr. Walker this morning say that in effect 08
20 calls are different in terms of competition because they are not the prime focus of the
21 customer when subscribing to mobile agreements. In other words it is an aftermarket,
22 would you agree with that?

23 A I wouldn't agree that they're different in the sense that they're somehow unique. There are
24 parts of the bundle which people are particularly sensitive to and there are parts that they are
25 not so sensitive to. The 08 call may not be one of the sensitive parts, but there are others
26 such as, for example, international roaming and international calling, and so I don't accept
27 that they are unique and somehow different to other geographicals in the bundle.

28 Q But is that not a relevant feature in terms of competition in relation to NTS calls, the model
29 of competition?

30 A The way I see it is that the mobile bundle is a complete bundle, everything on the phone is
31 in competition, if you like. I don't believe that mobile operators have a monopoly on SMS
32 messaging or international calls from their mobile phone because they have different prices
33 on them, if that's what you're asking me. I accept that there's different price sensitivity,

1 and they'll price them to the weight that the consumers give different calls, I do accept that,
2 but I think that competition happens over the bundle as a whole.

3 Q I see, but in here you were talking about specifically competition in relation to NTS calls,
4 but you did not mention the difference? The point I am really putting to you is you did not
5 mention there the difference that arises from the fact that actually purchasers do not take
6 this into account as a matter of great importance when subscribing to a mobile phone ----

7 A Right, I think if they don't take it into account, if it's not terribly important that tells me
8 about the elasticity of demand. But in terms of this statement I'm really responding to
9 Ofcom and the way it is painted that NTS calls and geographic calls are quite different
10 things with regulatory concerns at one end in one case and at the other in the other, and the
11 point I was trying to make is quite simply that actually NTS functionality is a billing
12 functionality on the core networks, a mobile operator competes across everything on the
13 OCP side, so it is not distinct there, and on the termination side of it a NTS call is a
14 geographic call and so it is regulated in the same way as a geographic call. That was the
15 context of ----

16 Q Right. You made a number of points there in para 10 of your statement. The first one is
17 you say there is very little difference in terms of the way the calls are terminated on the
18 terminating leg, but that does not tell you anything about the conditions of competition,
19 does it, that point?

20 A No, I don't think it does, no.

21 Q Then in 'b' you say that on the originating side both are included in mobile services bundles
22 offered by MNOs. I wanted to ask you though were you meaning specifically that NTS
23 calls are included within bundles generally?

24 A Not in the sense of what is in the bundle of calling, no I am not. I am meaning that it is sold
25 as part of the mobile platform if you like, the cell phone, all the services across it and I
26 might say that I think Ofcom has a similar discussion in the NCCN 500 about the minimum
27 package of services that are purchased on the fixed network.

28 Q Yes, and again in relation to 'c' I think the point here is as regards the mobile OCPs there is,
29 I think, no regulation on them which sets the level at which they should set a price in
30 relation to NTS calls, you would agree with that?

31 A Absolutely, but it is a highly competitive market and there are some very large companies
32 that have lost an awful lot of money in this market.

1 Q The points of similarity on themselves do not seem, apart from 'b' to be particularly strong
2 ones, but you did not mention the point of difference, which is the fact that these are taken
3 into account, given less weight by consumers when they subscribe to their mobile phones?

4 A But I do not see that there is a difference in competition. It is probably just because we are
5 coming at it from a completely different perspective. My perspective as that mobile
6 operators offer a mobile service, there are a whole bunch of services on that and they
7 compete over that entire package. The fact that there are different sensitivities within that
8 package does not alter the intensity of competition the operator itself experiences overall.

9 Q Is that not where it is relevant to take into account the fact that these calls affect the interests
10 of SPs of another set of consumers, so the model of competition is different, it has effects
11 on other parties?

12 A I don't know that it is a model of competition that is the problem here. The issue is that
13 Ofcom has particular objectives for those call types that are not being met, potentially not
14 being met by the competitive market, and that is a different issue as to whether I would, as a
15 competition economist, have concerns about the model of mobile competition; they are
16 separate concerns.

17 Q If I can turn to a similar topic, in relation to your comments about Ofcom's justification for
18 engaging in the analysis that it did in the FD. If you turn to para. 27 of your first statement,
19 at p.23. There you are:

20 "… simply stating that the 0845/0870 calls are provided in two-sided markets is
21 not sufficient justification for a departure from cost orientation."

22 In fact, Ofcom did a little more than that, did it not, because in the FD it set out its views
23 about market failure in para. 7.85?

24 A It may well have done that but I don't think it looked at this issue of whether or not there
25 should be like a fundamental correction to the two-sided market, at least my reading of the
26 draft and final determination is that they pretty much looked at it and said: "This has been
27 looked at in NCCN 500, it's a two-sided market, both sides' accounts, we need to balance
28 them" and away they went. My point is that right back at that first stage there was a very
29 fundamental question about is this a platform where cost based pricing would ever get the
30 right answer, in which case regulators are very careful to separate out problems on separate
31 sides of the market, or is this something related to the core, the underlying nature of the
32 platform itself which means that we have to use something other than cost base pricing, so I
33 don't think they took that step. I'm aware that they did describe in some detail the nature of
34 their concerns, I don't dispute that at all.

- 1 Q In relation to the point that you make at paras. 48 and 49 of your third statement, which is
2 tab 38, pp.23 and 24. As I understood your evidence this morning to Mr. Herberg, you
3 attach significance to the description of the problem, characterisation of the problem as a
4 vertical externality as being of significance, is that right?
- 5 A Yes.
- 6 Q Would you accept that the problem, and also the problem in relation to SP's could also be
7 described as an 'externality' affecting one of the parties of a two-sided market?
- 8 A Absolutely, and any retail situation where the retailer increases his prices can be described
9 as an externality that impacts downstream players, that's correct.
- 10 Q This may be more a question of law, but can I just ask you this: I understand you to be
11 saying in para. 51, which is over the page at p.24, the fact that you consider this is a vertical
12 pricing externality suggests that the remedy should also lie on that side of the market. It
13 may be that there is some agreement between us in the sense that if the problem is on the
14 retail side then obviously any action must affect the retail side, you would agree with that?
- 15 A Yes, yes, I would, that's correct.
- 16 Q Does it necessarily follow that the steps taken cannot come from somewhere else, cannot
17 come from a pricing solution in relation to the wholesale price?
- 18 A It generally doesn't. In most competition cases the importance of figuring out whether it's a
19 vertical pricing externality or a two-sided market problem is to locate the problem itself. In
20 telecoms markets in particular, which is most relevant, it would normally mean that the
21 regulator would stay with a cost based benchmark within the wholesale market. I,
22 personally, believe that the prime reason for that is that it avoids introducing unforeseen
23 consequences here and problems on the downstream side of the market. So it typically does
24 affect the way you deal with it. However, I do also accept that ultimately it is a question of
25 law as to what the constraints are and how you should run at it.
- 26 Q It may be rather a counsel of perfection, Mr. Muysert, but obviously the regulator has the
27 ability to target action at the retail market if that is what it wishes to do?
- 28 A They do, but that is one of the issues and that is one of the reasons that, typically, if you
29 give the OFT or the CC or indeed Ofcom, dealing with reconnection, they define a
30 termination market, an origination market and a wholesale market, even though there is no
31 dispute that it is a two sided platform, because they have different powers within those
32 different markets.
- 33 Q Is that in relation to competition or to SMP?

1 A Well, the Telecoms Act, but also in terms of competition proceedings, competition law,
2 they still go to some lengths to separate out the effects and consider how they should attack
3 it.

4 Q Is the answer or the point not this: if there is no ability on BT's part to emulate the
5 approach of the regulator there is nothing intrinsically wrong, is there, with a solution that
6 arises from wholesale pricing that has exactly the effect that a regulator targeting the retail
7 side might also have?

8 A I think, if you are asking me, is it possible that a company like BT could construct
9 something which would have the same effect, that's certainly possible. In practice,
10 regulators and policy makers are quite wary of these situations, and particularly with
11 dominant firms because of their ability to raise prices above cost and perhaps extract valid
12 earnings from other operators in the chain. There's a general question of might these things
13 happen in a commercial environment? That is one question. There is another question
14 altogether of a regulator or market power environment, how would you deal with it?

15 Q There is no finding here, is there, that BT has market or is dominant for this relevant
16 period?

17 A My understanding is that there is not, and I think that is one of the issues, that question of, is
18 there market power at the terminating end or at NTS hosting end, that has not really been
19 dealt with in depth.

20 Q Can I pick up also a point you made this morning about the CC and Ofcom 2003 and 2009
21 call termination points, these are dealt with – I do not know if you want to look at them – at
22 paras.25 and 26 of your first statement, pp.12 and 13. I think that deals with the 2009
23 position. Then your later statement deals with the 2003 ----

24 A The 2003, that's correct, yes.

25 Q Is not the point about this, first, that it was argued by the mobile companies that FNOs
26 might not pass on reductions in MCT that they pay to their customers and that might dilute
27 the benefits of regulation. That is the argument. The logic of their argument was, therefore,
28 that you should not regulate MCTs at all – mobile call termination at all – is that right?

29 A The logic of the argument was it meant that any benefits from regulating the mobile
30 operators' wholesale rates were diluted, because they weren't fully passed through to
31 consumers. In this particular case, a lot of alleged detriments, for example, handset
32 subsidies, and things like that, wouldn't be dealt with if it didn't actually affect the
33 consumers that the regulators were targeting.

1 Q Was not the approach here of Oftel and the CC that really they should not put off regulating
2 simply because subsequent problems might arise in terms of what then happened to the
3 benefits accruing to the fixed side because of the regulation? Would you agree with that?

4 A I think that is right, exactly, they would not have wanted to delay the wholesale regulation
5 of the mobile operators. The issue is that lack of pass through affects the benefits of those,
6 and the view was that if there was an issue in the retail market they would deal with it at a
7 later stage.

8 Q I think this morning you described that as a “no brainer”?

9 A If you read the decisions, you will find that there is only a couple of paragraphs, even
10 though this was a very serious issue in terms of how effective the actual remedy would be in
11 terms of its impact on consumers. It was a very serious issue – at least, in my view, it was a
12 serious issue. It’s dealt with very briefly in the decisions, and I think that’s because the
13 regulators considered it pretty much a no brainer as to how you deal with these things.

14 Q My point to you is going to be the fact that they chose not to deviate from the path of
15 regulation does not support a presumption that matters are always to be dealt with in the
16 markets as they arise. You are trying to draw a very general point from something that
17 actually seems a fairly natural conclusion for the regulator to have drawn?

18 A Yes, I would not suggest that it means always anything. This business is a very much a case
19 by case business. I do think that the economic structure of the problem is very similar
20 indeed, so perhaps there is some value in looking at the precedent.

21 Q Can I come back then to the position in relation to the hosting market in this case. You
22 have not formed a view on competition at the retail level in relation to 0845. I think you
23 also said that you had not formed a view, or you remained to be convinced – I cannot
24 remember your precise words – in relation to the existence of the vertical externality. To
25 what extent have you looked at the level of competition on the terminating side in relation
26 to 08 calls?

27 A I haven’t carried out an investigation beyond reviewing Ofcom’s documents, and the issue
28 of exactly what the situation in NTS hosting I don’t think was dealt with in any detail on
29 this investigation. In terms of actual termination of the geographic call, once it’s converted
30 into a geographic call, then that is just a standard call and it is regulated along with other
31 geographic calls.

32 Q Would you agree with this: if the hosting market is competitive, it follows that monies will
33 be passed on to SPs to a very large extent, and therefore there would be no problem for a

1 regulator to intervene in relation to a no requirement for the regulator to apply a cost
2 orientation approach?

3 A I do agree that if there was a highly competitive market there would be a fairly complete
4 pass through. I tend to believe that the rebalancing will be quite complete in the mobile
5 market. I don't believe that that means that the regulator can conclude that a passing on of
6 those funds is okay, for the reasons I think I covered briefly before lunch, which is that
7 these calls 0845/0870 are not designed to be revenue share numbers, at least that's my
8 understanding of where the policy is at the moment, and it's certainly BT's position
9 commercially, they don't advertise it. There's a question if you add revenue share and start
10 incentivising firms to use those, whether you finish up making the problem worse in the
11 long run. I don't think it's a simple question as to whether you count that as being a good
12 thing.

13 Q There are a number of points there that I would like to raise with you. The first is this: in
14 relation to whether or not your incentivising SPs as a result of these NCCNs, you
15 understand primarily that BT's case is that there is, in fact, an incentive to reduce the retail
16 prices, and therefore that will be of benefit and will alleviate to some extent the detriment in
17 relation to NTS calls and SPs particularly?

18 A Yes, that's certainly my understanding of BT's case. My concern with that is that the NTS
19 platform isn't a stand-alone platform, so there are multiple ways of contacting your SP,
20 which are not necessarily via the NTS platform, and not necessarily via your mobile phone,
21 so it is not clear just how large the detriment is. As I say, I do have concerns about
22 arbitrage if you increase revenue shares.

23 Q In relation to the size of the detriment, could you get bundle 13 out, please, and go to tab
24 3.1, p.163. Obviously there are general comments in this review that we have looked at
25 over the course of the hearing so far about the nature and the extent of consumer detriment.
26 Here, all I wanted to draw your attention to was paras.A2.130 and A2.131. I know you
27 have referred in a footnote to some of this material about the problems that SPs face. It is
28 reasonable, is it not, and indeed what the SP expects is that it ought to be able to influence
29 the retail price call by the caller and, if desired, choose whether or not to subsidise the call
30 or to take a revenue share or whatever, but that is the purpose, or one of the purposes, in a
31 way of the NTS system. Would you agree?

32 A Point 1, I do agree that the SPs, when they choose an NTS number, have some expectations
33 about what happens on the retail side of the market. I'm not engaged in this review, so
34 I don't know the detail behind this. I don't know what I can conclude from these statements

1 because I think it is a very different thing with a service provider as essentially an 09
2 service provider that's trying to sell a product, and it's having issues with the retail pricing
3 of it versus 0845 and 0870 which are quite different numbers in their function so, with
4 many 0845 calls maybe to a bank or a service provider like that, it's not at all clear to me
5 that they would have the same concern. So, I don't know who the SPs are, and I don't think
6 that I can draw any strong conclusions.

7 Q Well, you are right in the sense that there is obviously a range of SPs whose interests are
8 affected by the NTS mechanism as a whole. In relation to, you made some comments,
9 certainly in earlier answers, in relation to the, and this morning as well, about 0870 not
10 being, sorry, 0845 not being a revenue share mechanism, but have you looked at the
11 comments on revenue share in the review in relation to these numbers?

12 A On Simplifying Non-Geographic Numbers?

13 Q Yes.

14 A Not beyond that I understand that that is all moving away from them being revenue shares,
15 but I haven't been through this document in detail, no.

16 Q Could I ask you to turn to page 375, and figure A7.175 on that page, do you have it, sets out
17 the flow of volumes for 0845 calls, 2009. And then, on p.376, you get the flow of revenues.
18 And you see there that in fact the revenues to SPs are stated at £16 million.

19 A Yes.

20 Q And in fact at para.A7.179 it is explained there that:

21 "0845 generated a total of £469 million in 2009 ... 4% was paid to SPs".

22 So there is some revenue share.

23 A Yes, and it's terribly small, and my understanding from the analysis Mason study and other
24 documents is that most of that is ISP peak dial up traffic which doesn't originate on the
25 mobile network.

26 Q I am not sure I can quibble with your reference to the analysis Mason, but I do understand
27 that actually 0845 is not the dial up number, it is not relevant to 0845.

28 A Well, that's somewhat different to the references I've looked at.

29 Q But one of the points in relation to 0845 is this — they are supposed to be local call
30 numbers. You agree?

31 A Yes, that's my understanding that it was the intention, yes.

32 Q And the position is this: that service providers have to compensate TCPs to some extent,
33 because there is a very low retail price in relation to 0845 calls — in other words they are
34 charged at a local rate — notwithstanding the fact that actually many of them are transited

- 1 across the entire country and incur higher trunk charges than simply for a local call. Would
2 you agree with that?
- 3 A Yes. No, I understand that. Most SPs do pay for part of the service, absolutely, and that is
4 what you would expect with an 0845 —
- 5 Q So that one of the reasons why the figure is small is actually that payments are going the
6 other way from SPs to TCPs.
- 7 A Yes, exactly. So the SP's bill, so to speak, is reduced, and that is a case I understand is not
8 in dispute. What the issue is, is depending upon what happens in the mobile market, how
9 big the revenue share might be if this new system was put in place.
- 10 Q Yes. And in relation to 0870, if you turn on to p.388 and 389, where you have similar
11 figure for 0870, and of course the position in relation to 0870 changed recently as regards
12 the support for, regulatory support for revenue share. But, in relation to 0870 you have a
13 figure of £21 million on p.389 as being the sum received by SPs and, turning back to the
14 text at A7.2.42, you see there it is 12% of total revenues. So, again, there is or there was
15 considerable revenue share in relation to 0870.
- 16 A Yes. I think the only thing I'd say, really, is that I think those figures are really quite small;
17 and my understanding is that the analysis Mason flow of funds caught part of the year
18 before support for revenue share was removed. So, those funds overstate what might be the
19 case today.
- 20 Q Yes.
- 21 A That's my understanding.
- 22 Q And in relation to the points about the desirability of considering matters in market review
23 and regulation following such reviews, it is true, is it not, these things take a large amount
24 of time. And in fact the problem in relation to the 08 numbers has been known for a long
25 period of time and as yet there has been no regulatory solution at the retail end?
- 26 A No, I agree. And I think one of the issues is it does take a long time, but that's part of the
27 reason why the regulators seek to solve each part of the overall market puzzle path bit by bit
28 and try and get it right when they do so. The fact that the NTS system has taken such a long
29 time to be looked at is probably unfortunately, but it suggests to me that it's not one of
30 Ofcom's highest priorities. So, notwithstanding whatever the documents might say now,
31 I suggest that if it had a major source of concern, relative to all the other sources of concern
32 out there that attract Ofcom's, you know, limited resources, that it would have happened
33 faster.
- 34 Q And yet they do regard it, as the review says, as being a source of large consumer detriment.

1 A Well at this time it's obviously worked its way up the list but, you know, I still maintain the
2 point that Ofcom's under a lot of stress on a number of points, and I expect they'll put their
3 resource into the biggest issues first.

4 Q Thank you. I think those are all my questions.

5 THE CHAIRMAN: Thank you very much, Miss Lee. Miss Smith.

6
7 Re-examined by Miss SMITH

8 Q Just one point, I think on re-examination, Mr. Muysart. Miss Lee was asking you various
9 questions about the significance of revenue share on 0845 and 0870 calls, and on 0845 calls
10 in particular she took you to the Simplifying Non-Geographic Numbers review at figures
11 A7.5 and A7.6 and she put to you that the figure of £16 million in A7.6 that went through
12 by way of revenue share on 0845 calls was quite substantial, and you said:

13 "It's 4 per cent, it's very small, and my understanding from the analysis Mason
14 report is that most of it goes on dial up internet",

15 and she said, but did not give you an opportunity to respond:

16 "Well my understanding is that it is not dial up internet".

17 Could I ask you to look in your third witness statement, your third report at tab.38, and ask
18 you to look at para.17 and footnote 7. Perhaps you would like to comment on that?

19 A Yes. I mean, my understanding is taken from these Ofcom policy documents, and I thought
20 it was quite clear that 0845, that a large part of the traffic, and particularly revenue issue
21 traffic, dial up internet services, yes, I believe that is supported by the documents, and if in
22 doubt can be supported back to the source documents.

23 MISS SMITH: Thank you, I think those are all the questions I have.

24 THE CHAIRMAN: Thank you, Miss Smith, thank you very much, Mr. Muysert.

25 (The witness withdrew)

26 MR. READ: I think we have reached the end of the evidence.

27 THE CHAIRMAN: Well before half past four, well done everyone. Two points before we finish.

28 First, to respond to your general emissary, Mr. Herberg on the closing, we have no
29 difficulty in starting on Tuesday, and quite understand why the parties would want that to
30 happen. We suggest, perhaps for concern on time, we start at 10 o'clock on Tuesday, but
31 there are a couple of things we ought to make clear.

32 First, given the number of parties, and the fact that we will have to finish on 4.30 on the
33 Wednesday I think it is important that the parties send to Mr. Hurley a running order of who
34 is speaking and what order together with timings against the person speaking so that we can

1 run, not necessarily to the second stop clock, but one that is certainly to the five minutes,
2 because obviously for those further down the list it is just unfair if they are squeezed. If
3 parties have any concern about not being able to articulate their key points in two days, then
4 we are more than happy to start on Monday, perhaps Monday at 2 o'clock. I understand
5 you to say that you are happy with Tuesday to start, but that offer remains open if you want
6 to take it up. It may be we will rise for five minutes for you to discuss that in a moment.
7 The offer of written submissions also remains open, but again I take your point about the
8 impracticality of having major submissions, that given the number of points and the limited
9 amount of time we I would not say 'welcome' but we would accept further submissions on
10 minor points the parties feel they have not been able to cover in these two days by close of
11 play on 28th April. To deal with Mr. Read's point about new and unexpected points coming
12 up in those written submissions frankly I would not expect that to happen, but were that to
13 occur then we certainly would not disregard any responsive documents to those, but
14 knowing how responsible the parties are in conducting these proceedings I frankly do not
15 expect that to happen. So that is how we are minded to proceed subject to giving the parties
16 a few minutes just to consider the practicality of that.

17 The only other point I wanted to raise was the question of the diagram that we handed down
18 a couple of days ago.

19 MR. HERBERG: We are in the process of preparing one and we will be sharing it with the
20 parties this afternoon, and so I hope that probably before closing, but certainly by closing,
21 we should have something agreed.

22 THE CHAIRMAN: I am very grateful. I know it is a big-ish job and I appreciate the parties
23 doing it.

24 MR. HERBERG: And the other one that you asked Ofcom to do is in a similar stage of
25 preparation.

26 THE CHAIRMAN: I am grateful, Mr. Herberg. In that case we will rise for five minutes to
27 enable you to discuss logistics.

28 (Short break)

29 MR. HERBERG: Sir, I am happy to say again the agreement seems to be holding between the
30 parties. What everyone thinks is the best approach is first of all not to take up your kind
31 offer of Monday afternoon, to start on Tuesday morning, on the basis we would sit from 10
32 until 5 on Tuesday and 10 until 4.30 on Wednesday. We think it is possible to divide it up.
33 Could I perhaps just run through a running order and a timing order as to how we
34 contemplate it. It is proposed that the interveners would close first, so Vodafone for an

1 hour, 02 for an hour, then EE in its two roles, as it were, for an hour and a half. Then it will
2 be BT giving what time it agrees to Cable & Wireless, possibly three and a half hours, and
3 then Ofcom ----

4 THE CHAIRMAN: Just on that, Mr. Read, you will liaise with Mr. Beard?

5 MR. READ: Do not worry, Mr. Harding is in court and I have already spoken to him.

6 MR. HERBERG: Then Ofcom for three and a half hours. Then there is provision at the end for
7 EE and BT to reply, and that is anticipated to be strictly limited to new points arising out of
8 what comes out of the other submissions, that would be on top of the 10.5 hours you
9 suggested. We calculate there is an extra half hour floating around, even subtracting the
10 five minutes for breaks and things. So if they needed 15 minutes each, or something in that
11 region we should still be okay timewise, but it might not even need that much, but there is
12 that slack in the timetable and everyone is content to allow that to be extra on top if that
13 stage is reached.

14 THE CHAIRMAN: Well very generous of you, Mr. Herberg, that seems very sensible.

15 MR. HERBERG: That would take us to the end of Wednesday. Everyone will seek to put
16 everything they can in those closing submissions whether delivered orally or supplemental
17 written documents at the same time, so that no one is anticipating that they will need to take
18 up the offer of further written materials, but of course we all appreciate it is there if we are
19 *in extremis* and driven to that.

20 THE CHAIRMAN: That sounds very satisfactory and in that case we will say 10 o'clock on
21 Tuesday morning. Thank you all very much.

22 (Adjourned until 10.00 am on Tuesday, 19th April 2011)

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