

IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1146/3/3/09

Victoria House,
Bloomsbury Place,
London WC1A 2EB

21st October 2010

Before:

MARCUS SMITH QC
(Chairman)

PROFESSOR PETER GRINYER
RICHARD PROSSER OBE

Sitting as a Tribunal in England and Wales

BETWEEN:

BRITISH TELECOMMUNICATIONS plc

Appellant

– and –

OFFICE OF COMMUNICATION

Respondent

– and –

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

Interveners

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

HEARING
(Partial Private Circuits)
DAY TWO

APPEARANCES

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

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

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

1 THE CHAIRMAN: Yes, Mr. Saini.

2 MR. SAINI: Sir, can I just mention two matters of housekeeping. First of all, we have an
3 insertion into the authorities bundle, volume 1 of 2. These are just some sections of the
4 Communications Act 2003 which are relevant and they relate to the imposition of SMP
5 provisions and I will refer to those in due course.

6 THE CHAIRMAN: Where should these go, Mr. Saini?

7 MR. SAINI: At the back of authorities bundle 1, tab 7, the back of existing tab 7 just before tab 8.
8 In addition, I am sorry to add to the paper in this case, there is a new bundle, ADB4, which
9 has various documents to which I will make reference this morning. We do not need to
10 look at that at the moment.

11 Just to remind everyone where I was, as I indicated when I started, I am going to structure
12 my submissions in four main parts. The first part concerned the nature of the dispute. The
13 second part, which I am still on, concerns the conditions. The third part will be an overview
14 of the methodology, and the fourth part will be part of the methodology in more detail.

15 If I can go back to the second matter, which is the conditions, could I ask the Tribunal,
16 please, to have out, the extract from the authorities, the one that we have just inserted at tab
17 7, it is important when looks at the cost orientation in particular to have very much in mind
18 the elaborate procedure that Ofcom had to go through before they imposed the SMP
19 condition. Could I ask you to please pick it up first at s.78 of the 2003 Act. Section 78(1)
20 provides that:

21 “... a person shall be taken to have significant market power in relation to a market
22 if he enjoys a position which amounts to or is equivalent to dominance of the
23 market.”

24 So BT would have had to have been found to have a dominant position in the trunk segment
25 market. One sees, carrying on through speedily for the moment, s.79 provides for the
26 identification of specific markets. There are notification processes. If one jumps a few
27 pages ahead to s.87, once this elaborate procedure has been undertaken, and this was the
28 elaborate procedure which led to the LLMR review which you see in AD2, tab 2, which is
29 the LLMR statement, once that procedure is undertaken then conditions can be imposed.
30 Could I please ask the Tribunal to look down at s.87(6), these are the particular conditions
31 that may be imposed. If one just traces down through this, and stop, please, at sub-section
32 (9), these are particularly relevant conditions given the present dispute. Sub-section (9)
33 says:

1 “The SMP conditions authorised by this section also include (subject to section 88)
2 conditions imposing the dominant provider –

3 (a) ... price controls ...

4 (b) such rules as they may make in relation to those matters about the recovery
5 of costs and cost orientation;

6 (c) such rules as they may make for those purposes about the use of cost
7 accounting systems; and

8 (d) obligations to adjust prices ...”

9 Can I ask the Tribunal to underline, please, two particular sub-sections which are sub-
10 sections (b) and (c), so both rules about cost orientation and recovery of costs; and cost
11 accounting systems. As I will show the Tribunal in due course, not only was a cost
12 orientation condition imposed upon BT, but also a cost accounting condition, which went
13 hand in hand with the cost orientation condition and one needs to look across the page,
14 please, to s.88 because we see subsection 9 is subject to s.88, and this is a very important
15 section, s.88 because it sets out certain hurdles which Ofcom must overcome before setting
16 these types of pricing conditions – cost and pricing conditions in subsection 9. You will see
17 that 88(1)(a) provides that Ofcom will not set one of these pricing conditions except where
18 it appears to them from the market analysis carried out for the purpose of setting that
19 condition that there is a relevant risk of adverse effects arising from price distortion. “(b)”
20 the Tribunal can read for itself, and then (3) is particularly important:

21 “For the purpose of this section there is a relevant risk of adverse effects arising
22 from price distortion if a dominant provider might

23 (i) so fix or maintain some or all of his prices at an excessively high level, or

24 (ii) so as to impose a price squeeze,

25 as to have adverse consequences for end users of public electronic
26 communications services.”

27 I make all of these points because they establish that prior to setting the SMP condition that
28 we are concerned with in this appeal, Ofcom had conducted a market analysis, had decided
29 that BT were in a dominant position and had decided that end users of public electronics
30 communication services and, indeed, those who bought services directly from BT, such as
31 communications providers, persons in those groups required protection from abusive
32 pricing.

33 That exercise having been conducted already when it comes to analysing matters of
34 economic harm or likely economic harm, when the issue of breach of the cost orientation

rule is in issue, one cannot forget that it has already been decided without any appeal against BT that BT has the ability to abuse its dominant position and protection is required as regards pricing.

If I could ask the Tribunal to put that away for the moment and return to the LLMR statement, which is in additional bundle 2. This statement which you have looked at parts of – I took you to parts of it yesterday to identify the particular conditions, but there are other more detailed parts of the text I need to take you to now, this is the product of the exercise that we have seen set out in the Statute, in other words an SMP analysis, a conclusion that there is significant market power, and a decision to impose certain conditions; this is the product of that process.

If I can just identify for the Tribunal rather rapidly some particular passages in this document. I would like to focus on a few more. Could I ask the Tribunal, first of all, to go to the first page. There is a very useful summary there of how the world changed when the new Regulatory Framework came into force on 25th July. Going over the page to p.2, we have a summary, and if you could go to S8 you will see the identification in the last bullet point of a separate market there for wholesale trunk segments at all bandwidths.

On the facing page under S13, there is an assessment that BT has significant market power in the whole trunk segments market at all bandwidths, the last bullet point under S13.

Then at S19, these are the Conditions summarised that are proposed to be imposed. One sees that as far as trunk is concerned there is not going to be a price control, one sees from the fourth bullet point, but immediately above that there is a basis of charges obligation which includes both cost orientation and cost accounting.

Could I then ask the Tribunal to go to the body of the report, first of all, p.79, where we have a useful paragraph at 3.72 going on to 3.74, which summarises Ofcom's conclusion in relation to significant market power in wholesale trunk segments. It is particularly 3.74 that I would emphasise:

“BT is able to behave, to an appreciable extent, independently of competitors and customers. This is possible principally because of the following factors:

- * the ubiquity of BT's infrastructure and the number of trunk routes subject to little or no competition;
- * barriers to entry;
- * economies of scale; and
- * BT's vertical integration.”

Then I would emphasise the following passage:

1 “It is evidenced by BT’s ability to price above the competitive level, as discussed
2 in Chapter 2, and the relatively high percentage of terminating segments with
3 which trunk segments were purchased from BT.”

4 So in 2004 Ofcom had already identified that BT was pricing above the competitive level
5 for trunk alone, and they had made that clear. That assessment was an essential aspect of
6 the finding that there was significant market power.

7 Just to finish this conclusion, if the Tribunal would please go two pages ahead to p.82,
8 para.3.89, you will see, if I may read that:

9 “For the reasons set out above, in particular BT’s ability to price on a national
10 basis at a level considerably above that which would be expected in a competitive
11 market, Ofcom has concluded that BT has SMP in the market for wholesale trunk
12 segments.”

13 Miss Rose has whispered to me that I should read 3.88, which I am sure is very relevant, so
14 I will read that:

15 “Ofcom has further taken note of the fact that despite it appearing that there is a
16 prospect of competition on major trunk routes, BT has nevertheless been able to
17 maintain its prices significantly above the competitive level. A comparison of the
18 per kilometre charges for PPC terminating segments (which should be priced at
19 cost) and trunk indicates that the trunk charges are up to four times higher. Ofcom
20 would expect trunk charges to be lower than those for terminating segments due to
21 economies of scale. BT’s ability to price at this level strongly suggests that other
22 communications providers are not able to act as a competitive constraint on BT’s
23 ability to price above the competitive level and that, as such, BT has SMP in the
24 market for trunk.”

25 I am grateful for that paragraph being drawn to my attention.

26 One thing that is clear from all these passages is that it cannot have been said by BT that at
27 the end of the LLMR they went away believing that Ofcom was perfectly happy with the
28 price of their trunk segments, and specifically because Ofcom had imposed a price control
29 on terminating which was too low. The position could not have been more different.

30 One particular passage that is relevant in terms of the pricing analysis that Ofcom undertook
31 in deciding there was significant market power, and this is a passage that you have already
32 been shown, but I need to ask you, please, to go back to it, if one goes ahead in this bundle,
33 please, it is annex B at p.340. This is the basis for Ofcom’s concern that BT has been
34 pricing substantially above the competitive level. This was taken from BT’s financial

1 statements. Ofcom said in B110 that it was not clear how these figures had been calculated.
2 That is a fair enough point. However, one point which is not in doubt, and I do not believe
3 there is any dispute between the parties, is that the LRIC floor and the SAC ceiling there are
4 DLRIC and DSAC.

5 So BT, itself, was using those concepts and those parameters in its own accounts, and
6 identifying how far its charges for trunk in these three different denominations exceeded
7 SAC. That is the DSAC ceiling.

8 At B112 at the bottom there Ofcom fairly said that this may not be conclusive without
9 further investigation, but *prima facie* it suggests that BT is able to price independently of
10 competitors, and as such is in a position of SMP.

11 Can I ask the Tribunal, please, to go back to p.192 in this document, and, perhaps to make it
12 clear, if one goes back to p.191 to see how this section starts, you will recall that under the
13 Communications Act, which I showed you a few moments ago, there are various hurdles
14 which Ofcom had to overcome before imposing SMP conditions, and in particular
15 conditions concerning pricing and cost accounting. Ofcom considers those hurdles at 8.37,
16 8.38 and 8.39. Can I please pick it up from 8.40 and read from there:

17 “Section 87(9) authorises the setting of SMP services conditions imposing the
18 dominant provider rules concerning the recovery of costs and cost orientation.
19 As BT has been identified as having SMP in this market, the availability of
20 wholesale trunk segments at cost oriented prices will ensure that communications
21 providers were able to compete in the retail leased lines markets in such a way that
22 it results in downward pressure on retail prices and provides the benefits of
23 competition to customers.”

24 The next passage is particularly important:

25 “It might be argued that the Competition Act should be used to avoid excessive or
26 predatory pricing. However, Ofcom considers that sectoral tests are likely to be
27 more stringent and more effective than the Competition Act, giving the SMP
28 communications provider less latitude and providing greater certainty for access
29 customers.”

30 So Ofcom’s rationale for imposing the SMP conditions with which we are concerned in this
31 appeal was that ordinary Competition Act remedies, *ex post* remedies, were not going to be
32 sufficient to deal with BT’s significant market power and its ability to charge excessive
33 prices. Therefore, you needed something which was going to handcuff them. It was
34 expressly decided that they had to be provided with less latitude in their pricing. I

1 emphasise again that this section is headed “Basis of charges obligations”, both as regards
2 to cost orientation and cost accounting systems, and I am going to come back to the cost
3 accounting aspect. If I could ask the Tribunal please to look at the facing page at 8.48.
4 This is a description of the condition. 8.48, this condition H3:

5 “The condition sets out the charges for service should be reasonably derived from
6 costs of providing those services. It further states that the cost must be calculated
7 in a forward looking incremental cost approach allowing an appropriate mark up
8 for the recovery of common costs including an appropriate return on capital
9 employed. The condition will apply across all services within this market, this
10 means that the price of all services provided BT in the market should be based on
11 LRIC and allowing an appropriate mark up for recovery of common costs. Ofcom
12 confirms that all new services that are introduced into this market will also be
13 covered by the same rule.”

14 I will not read any more of that. It is clear here that price for individual services will have
15 to be justified according to this criterion. There is not a hint here anywhere of the
16 suggestion that you can satisfy this condition by, for example, aggregating the price of trunk
17 and terminating. Then if I could ask the Tribunal to go over to p.194 to the conclusions in
18 relation to this aspect:

19 “Having considered the responses to the draft notification, Ofcom has concluded that it is
20 appropriate to impose a condition in these markets in the form set out at Annex D. Ofcom
21 recognises the concern of communications providers that the condition gives too much
22 freedom to BT and the effect of this will be to dampen competition in downstream markets.
23 There is a balance to be struck here. Giving more freedom to BT will have the effect of
24 intensifying competition on certain routes, which is beneficial to the end user. Ofcom
25 believes that it has struck the balance appropriately. Nevertheless, Ofcom will be alert for
26 unwanted effects of this approach and will propose corrective measures, if it proves
27 necessary.”

28 Miss Rose reminds me at 8.58, I was going to come back to this point a bit later but I will
29 read it now:

30 “8.58 Ofcom considers it premature to carry out a full analysis of the cost to BT
31 of providing trunk and intends only to carry out such an assessment if it receives
32 evidence-based complaints that the trunk prices set by BT are not cost oriented.
33 Similarly, Ofcom notes communications providers concerns about transfer charges

1 and BT's ability to bill accurately and will look at any complaints on these issues
2 that it receives once the obligations take effect."

3 So it is absolutely clear here that a full analysis of trunk had not been conducted, but if a
4 complaint was received then an assessment would be carried out. It cannot be suggested, as
5 BT appear to suggest, that in fact in this process trunk and terminating had been compared
6 and it had been concluded that trunk prices, although high, were justifiable because they
7 offset effectively a loss making service (terminating segments). There is simply no analysis
8 here specifically of the costs of trunk, other than they appear to be very, very high.

9 I have mentioned cost accounting, and I need to show you in this report what was said about
10 cost accounting obligations, that is at p.251. I have mentioned cost accounting and I need to
11 show you in this report what was said about cost accounting obligations, that is at p.251. If
12 I can just preface this by explaining where this is going, you recall that at the end of Mr.
13 Read's submissions yesterday he showed you some accounting information that BT had
14 been providing and lo and behold we see BT reporting DSAC and DLRIC. Suddenly they
15 started reporting those figures in their annual accounts, and I will come back to where that
16 leaves Mr. Read's submission that somehow BT did not really know that DSAC and
17 DLRIC were important, or that they were going to be applied as parameters for the
18 assessment of PPC charges; I will come back to that point. But that reporting flows from
19 the imposition on BT of a cost accounting obligation which went hand in hand with the cost
20 orientation obligation so the way in which BT was going to show it was ensuring its prices
21 were cost oriented was to publish DSAC and DLRIC figures. It is rather a tortuous journey
22 to that conclusion, but if I can start at 10.1:

23 "This chapter discusses the financial reporting obligations that may be imposed on
24 BT and Kingston to ensure that a number of the obligations set out in Chapters 5
25 to 9 are met. In particular, obligations of cost orientation, price controls and non
26 discrimination can require the imposition of financial reporting regimes to monitor
27 dominant providers' compliance with these obligations. This chapter discusses in
28 some detail the imposition of obligations for cost accounting systems and
29 accounting separation."

30 If I could ask the Tribunal to turn over para. 10.10 at p.252:

31 "Given the imposition of LRIC with an appropriate mark-up for the recovery of
32 common costs on both BT and Kingston, and a charge control for BT, Ofcom is
33 proposing that BT and Kingston should maintain appropriate cost accounting
34 systems, that demonstrate that the obligations of cost orientation and (for BT) the

charge control are being met. This will enable Ofcom to monitor compliance with those obligations.”

Then we see at 10.11 that cost accounting obligations will apply in particular – see the last bullet point –a to wholesale.

Then 10.13 at p.253:

“In order to demonstrate cost orientation of a service or product, it is necessary for the dominant provider to establish cost accounting systems that capture, identify, value and attribute relevant costs to its services and products in accordance with agreed regulatory accounting principles, such as cost causality.”

The Tribunal can perhaps read the rest of that paragraph. Having decided to impose a cost orientation obligation and having indicated in outline that in principle a cost accounting principle was to be imposed a consultation process went forward, and at the end of that consultation process a further report was prepared which set out the precise accounting obligations. If one can put this LLMR report to one side for the moment and please take up the new bundle I put in this morning, ADB4, and could you go to tab 3. You will see from the cover page of tab 3, that this is the final statement and notification on cost accounting. At 1.1 one sees:

“This document sets out Ofcom’s final decision on the detail of the regulatory financial reporting requirements necessary to implement the remedies identified by the market reviews in a proportionate and appropriate manner.”

Just jumping ahead to p.9, 2.24, could you read 2.24 to 2.26, which explains why Ofcom requires cost accounting information in particular to demonstrate compliance with cost orientation conditions. The two specific conditions imposed, one sees, first of all describe in general terms at p.21, and I would ask the Tribunal to underline para.4.4, which is Condition OA2, which we will look at in a moment. That gives Ofcom the power to make directions under the conditions. Then on the facing page Condition OA5, which requires BT:

“... on an annual basis, to prepare regulatory financial statements, secure an audit opinion on them, deliver the regulatory financial statements to Ofcom ...”

etc. Those are the conditions in outline.

I should also mention while passing, if one goes over to p.24, one of the requirements upon BT at para.4.28 was to prepare a wholesale catalogue of each of the services. So BT’s trunk service in particular was the subject of this requirement, so a separate wholesale catalogue had to be prepared for that particular service.

1 Running through this rather quickly, if one goes to p.48, these are the actual conditions. I
2 have shown you what they were in summary. The two conditions to underline are OA2,
3 which is:

4 “Ofcom may from time to time make such directions as they consider appropriate
5 in relation to BT’s Cost Accounting System, Accounting Separation System and its
6 obligations under these conditions.”

7 Then OA5:

8 “BT shall in respect of the Market, Technical Areas and the Disaggregated
9 Activities (as applicable) for each Financial Year:

10 a. prepare such Regulatory Financial Statements as directed by Ofcom from
11 time to time in accordance with the Accounting Documents ...”

12 Jumping ahead, please, to p.89, just above the second hole punch, this is a specific
13 direction:

14 “BT shall, for the purposes of condition OA5 and as appropriate, prepare, secure
15 an appropriate audit opinion in respect of, deliver to OFCOM and publish the
16 Regulatory Financial Statements in accordance with Annexes A, B and C to this
17 Direction.”

18 That is saying, in summary, that you have got to prepare a statement in accordance with
19 annexes A, B and C. One sees what annex A requires at p.91, and if one goes down to the
20 fourth bullet:

21 “SoCC Ext = statement of costs and charges for wholesale service supplied in the
22 market, which are only Internal Wholesale Services ...”

23 and it is meant to be provided in the form of annex 34. What we have done is, at tab 4,
24 provided a sample of annex 34, and you will see, and I do not believe there is any dispute
25 about this, that annex 34 requires BT on a service by service basis to identify DLRIC floors
26 and DSAC ceilings. So it cannot be doubted that BT was well aware that one of the ways in
27 which its compliance with cost orientation was going to be regulated was through its
28 publication of DSAC and DLRIC figures. There were being asked to publish this material
29 every year.

30 If one can please put this away for the moment ----

31 MR. READ: Sir, just to inform you, I only saw these documents today, and just my learned
32 friend leaves it, the position is actually set out in para.13 of annex 2 to our notice of appeal,
33 because we think that, in fact, that annex 34 unfortunately has not been fully copied in
34 there. I do not think there is any dispute about it at all, because I think we end up with it,

1 but it goes back to the point that I was making yesterday that, in fact, the annex 34 did not
2 specify individual trunk segments at that stage. Because annex 34 has not made it into the
3 bundle I thought I ought to draw that to your attention.

4 MR. SAINI: It may not be a big point ultimately, because I am trying to get to DLRIC and
5 DSAC, but we can actually look at what BT prepared. Mr. Read showed you a few of
6 those, but can we put that bundle away and go to bundle DF2. To put this back into context,
7 remember that BT are now being required to produce this detailed information. Can we go
8 to tab 13, one sees there for the year ended 31st March 2006 a component floor and
9 component ceiling. We see that identified for each of the separate trunk denominations. So
10 we have 2 Mbit/s, 34, 140, 622, etc. Then one sees, if one takes the second half of this
11 table, under partial or private circuits 2 Mbit trunk one sees an average charge for the year
12 of 102.24. I emphasise that this is BT's own interpretation of what it is meant to be doing.
13 What is surprising is the suggestion that BT would now be indicating through Mr. Read that
14 it did not really understand that DSAC and DLRIC had any significance.
15 If I could ask the Tribunal, please, to go over to the next page, which is the Current Cost
16 Financial Statements for 2007, again annex 34, here you will note that BT has made the
17 position even more clear. It is rather hard to read this, but if you could look at the top does
18 the Tribunal see section 4.8?

19 THE CHAIRMAN: Yes, we see that.

20 MR. SAINI: If I may read under "Market summary":

21 "Purpose of statement to provide more detail on financial performance and ..."

22 I emphasise the word –

23 "... first order tests of compliance with cost orientation and non-discrimination
24 obligations."

25 BT, itself, is fully aware that it is publishing, and I do not believe there is any dispute about
26 this, separate DSAC and DLRIC figures for trunk segments and their separate
27 denominations, and describing the floors and the ceilings. So perhaps the Tribunal can just
28 write in, because I do not believe there is any dispute about it, if one goes to the right hand
29 side of the table in the middle, you will see under the headings "Unaudited LRIC floor" and
30 "Unaudited LRIC ceiling", that DLRIC floor, and all it says LRIC ceiling, that is the DSAC
31 ceiling. The same point applies for the next year, 2008, p.11. The same applies for 2009,
32 p.15.

33 It is said by Mr. Read, "You saw these figures, why did you not do anything about it?"

34 Ofcom had made its position clear, which is that if a customer makes a complaint about

1 trunk charges then it will investigate. What Mr. Read cannot say is that because BT
2 published these figures and Ofcom did not act, unilaterally it is now somehow precluded
3 from taking into account these breaches of the DSAC ceiling.

4 We know that in some years – for example, 2004/2005, it is clear in the determination – the
5 DSAC ceiling was exceeded, but Ofcom looked at the reasons in that year and the
6 underlying financial data and they found that, despite it having been exceeded in that year,
7 they did not believe there had been, in fact, any overcharging requiring action by Ofcom.
8 This shows that this is a first order test requiring further examination. It is not a first order
9 test just in Ofcom’s words, but also in BT’s words.

10 I have just been told by Mr. Myers that I made an error in what I have just said which is
11 that, in fact, the DSAC ceiling was not exceeded in 2004/2005. That was a bad point and I
12 apologise for that. That was in the accounts apparently, but not in the final determination.

13 Sir, can I ask you, please, to put DF2 away and to return to ADB4. So far I have been
14 making the point that BT perfectly well understood that the DSAC ceiling and DLRIC floor
15 were intended to be a first order test of compliance and that is why they were publishing
16 those figures as regards each separate denomination within the trunk market.

17 However, it does not stop there, because BT itself, in its own primary accounting
18 documents, which we are going to look at now at tab 6, and these are the documents that
19 follow immediately after the reviews of the leased line market. In its own documents –
20 which we accept that these primary accounting documents are published as a requirement
21 by Ofcom but they nevertheless contain BT’s own words, I do not think there is any dispute
22 about that – if one looks at what BT itself was saying about cost orientation it is clear that
23 they perfectly well understood the importance of DSAC and DLRIC.

24 Can I begin at p.i, which is the fourth document in from the beginning, again there is a very
25 helpful description here of the new regulatory landscape, and at ii and iii BT set out that
26 Ofcom has found that BT has got significant market power in various separate markets.
27 The words “separately identified” are those of BT, and at xiii one sees wholesale trunk
28 segments. Can I ask the Tribunal to go to vii under the heading “Accounting Documents”,
29 it says:

30 “The Regulatory Financial Statements are prepared in accordance with the
31 Accounting Documents, where the Accounting Documents means together the
32 Primary Accounting Documents, the Secondary Accounting Documents and either
33 the Wholesale Catalogue or the Retail Catalogue as appropriate. The Primary

1 Accounting Documents set out the framework under which the statements are to be
2 prepared.”

3 These are the statements that we have been looking at. Then:

4 “These Primary Accounting Documents consist of [the following] ...”

5 and can I ask the Tribunal to go down to 5:

6 “Long Run Incremental Cost (‘LRIC’) Methodology – means the long run
7 incremental cost principles, procedures and processes which form the framework
8 under which long incremental costs are determined by BT. This document sets out
9 the principles followed to derive the long run incremental costs.”

10 If one can then please go to (xxi) under the heading: “Wholesale Trunk Segments” there is a
11 summary there of what trunk segments are, what the market consists of and if I could ask
12 the Tribunal please to focus on the third paragraph from the bottom:

13 “Given the position of LRIC with an appropriate mark-up for the recovery of
14 common costs on BT, Ofcom determined that BT should maintain appropriate cost
15 accounting system to demonstrate the obligation of cost orientation are being
16 met.”

17 If we can jump quite a few pages ahead now to the body of this document to p.47 and here
18 we have BT’s own description – I emphasise BT’s own description – of the long running
19 incremental cost methodology. This is actually very useful, not just because of the points I
20 am going to make about it but as what I call a “Noddy’s guide” as to how LRIC works,
21 DSAC works, DLRIC works.

22 So just running through, before we get to DSAC and DLRIC, I will just skip over a few pages,
23 there are very useful descriptions of floors and ceilings, LRIC definitions but if I could
24 please ask the Tribunal to stop at p.52, para. 5.3. That is a model there of BT’s inland
25 network model. The Tribunal will know that PPCs that we are concerned with in this
26 appeal sit within the core, which is the left hand block of that model. Were there any doubt
27 if one looks at the facing page one sees a very helpful description and bullet points of what
28 is within the core and the last but one bullet sets up inland private circuits. So bearing in
29 mind we are dealing with the core, BT go on to describe again in their own words what they
30 regard as being the appropriate approach to cost orientation in respect of network
31 components within the core and if I could ask the Tribunal please to go to 5.33, and luckily
32 this is not at all complicated, this part. As far as the core is concerned, if one looks at the
33 third paragraph please:

1 “A way of ensuring that fixed common costs are recovered in the revenues is to
2 conduct combinatorial tests whereby the aggregate revenue of a service straddling
3 the fixed common costs are required to equal or exceed the LRIC of these services
4 measured as a single increment.

5 Combinatorial tests have not been specified in the case of the Core increment.
6 Instead, the recovery of the Intra Core Fixed Common Costs has been prescribed
7 by Ofcom through the use of distributed LRICs (‘DLRICs’) in determining cost
8 floors. This restricts pricing flexibility by setting a price floor for components in
9 excess of the actual LRICs. Ofcom uses this restriction in order to avoid complex
10 combinatorial tests.”

11 So that is the floor. In BT’s own words they are saying this has been prescribed by Ofcom,
12 it has been prescribed for the core, we note from the preceding page that the core covers
13 PPCs, how can it now be said by BT that they had no idea that PPCs were going to be
14 regulated in this way, that is the flaw. The same applies to the ceiling. Happily, jumping a
15 few pages ahead, 5.3.5 one sees at p.58, a very simple description of DSAC. So having the
16 DLRIC floor they say at 5.3.5 a similar approach is taken with stand alone costs in order to
17 drive ceilings for individual components.

18 “The economic test for an unduly high price is that each service should be priced
19 below its Stand Alone Cost. As with price floors this principle also applies to
20 combinations of services. Complex combinatorial tests are avoided through the
21 use of DSACs which reduce pricing freedom by lowering the maximum price that
22 can be charged. This results in ceilings for individual components that are below
23 their actual SACs.

24 SACs of two network elements are calculated, Core and Other Wholesale Network
25 components taken together. Where ceilings to individual components are needed
26 DSACs are ‘distributed’ between the components comprising these increments.”

27 So far from it being the case that the use of DLRIC and DSAC came as a bolt from the blue
28 to BT when they were referred to as parameters by Ofcom, in fact, as long ago as 2005
29 immediately after the LLMR Review BT itself articulated the nature of these parameters and
30 their purpose specifically that they were to avoid the use of combinatorial tests and also that
31 they were deliberately restrictive. Whatever BT may say about what they were
32 understanding in 1997, 2001, 2002, which is a matter for evidence, there is no doubt that
33 when it came to the particular conditions with which we are concerned, it was absolutely

1 clear to BT that DLRIC and DSAC were important parameters and that they set the floor
2 and ceiling respectively.

3 I am about to turn to another document, which will take some time, would that be a
4 convenient time for a break.

5 THE CHAIRMAN: That sounds like an excellent idea, Mr. Saini, five minutes.

6 (Short break)

7 MR. SAINI: Sir, by way of a global overview, Ofcom's approach to the issue of overcharging
8 can be broken down into the following parts. The first part was to consider, as a first order
9 test, whether the charges levied for trunk segments exceeded DSAC. There is going to be a
10 dispute in this case about what first order test means, particularly with the experts. We say
11 that a first order test in this context means the indicators are that BT or another provider has
12 acted in a way to abuse its significant market power by overcharging its customers. It is a
13 very significant indicator. That is what first order means.

14 We have just seen that BT itself described DSAC as a first order test. The second stage for
15 Ofcom was to take the result of that first order test and not to apply it mechanistically but
16 then to consider at least seven other matters. I can list these by way of an overview. The
17 seven other matters that Ofcom considered were, first of all, the magnitude and duration of
18 the amounts by which charges exceeded DSAC. Secondly, whether charges above DSAC
19 could have caused economic harm to BT's consumers, thirdly, the evidence on BT's rates
20 of return on 2Mbit trunk compared to its cost of capital. Fourthly, when charges were
21 below DSAC, whether or not such charges might nevertheless constitute over charging,
22 because you will be aware that even charges below DSAC might amount to overcharging.
23 Fifthly, BT's cost data on individual service SAC and combinatorial tests, sixthly, BT's
24 circuit analysis; and seventhly, evidence on international benchmarking submitted by BT.
25 So we submit that there was no relevant factor left out of the analysis by Ofcom.

26 THE CHAIRMAN: Mr. Saini, just to be clear, this list that you have just given us is a list of the
27 facts that were taken into account by Ofcom as a second order test in this case, you are not
28 saying that this is a comprehensive list?

29 MR. SAINI: No, in this case – I am dealing with this case.

30 THE CHAIRMAN: I understand.

31 MR. SAINI: In other cases, for example, one might not have any material on combinatorials, but
32 in this case there was some material so this was the approach in this particular case.

33 THE CHAIRMAN: Secondly, as a follow on from that, yesterday Mr. Read made some points on
34 the delay between having, as it were, established the DSAC figure. In other words,

1 although it comprised part of an *ex ante* test for compliance with price or cost orientation
2 you only study the figures later on, that presumably would be a fact you would take into
3 account in your fifth point?

4 MR. SAINI: Absolutely. It is important to bear in mind as well, having just looked at those
5 primary accounting documents, BT itself clearly considers that DSAC is a useful figure. It
6 is not something which is only of historic interest, it is something which can guide its future
7 pricing, otherwise it would be a meaningless parameter. That was a broad overview of
8 Ofcom's approach. I am going to turn to my fourth head, which is the particular matter on
9 which I want to make more detailed submissions in relation to the methodology – I should
10 emphasise that it is not suggested by my clients that DSAC is the only test available.
11 In fact that brings me on to the first of my four detailed points under head 4. I will give you
12 the points first of all before I develop them. The first is the use of DSAC, the second is the
13 issue of aggregations, the third is BT's use of combinatorials, and the fourth is the issue of
14 economic harm.

15 I said a few moments ago that DSAC is not the only test, in fact one knows for example at
16 the time of Phase 1 and Phase 2 directions which Mr. Read took you to yesterday, another
17 test was put forward which is stand alone cost plus combinatorials. So if you can produce a
18 satisfactory set of combinatorials, that is an alternative test. But in this case both we and
19 BT as we know regarded DSAC as the starting point.

20 If I can just say a few words about DSAC. Any cost orientation condition has to be
21 interpreted in a way which balances the interests of the dominant provider and the interests
22 of its customer, there has to be a balance between the two. So you have to give someone
23 like BT sufficient pricing flexibility, but equally you have to bound that flexibility to
24 prevent exploitation of market power. Ofcom's view was that DSAC as a first order test
25 provides a reasonable balance between those two matters. There are at least three separate
26 reasons why Ofcom considered DSAC to be appropriate.

27 If I can give you the headings of those before developing them, the first is latitude, the
28 second is rate of return, and the third is transparency. I will first of all address latitude and
29 ask the Tribunal to take out a table which is in Mr. Myers' statement in CB2, p.495. I take
30 you to these bundles, because I do not believe that, unlike other tables Mr. Myers has
31 produced and Mr. Budd has produced, I do not believe there is any dispute about the figures
32 in these tables, or the conclusions that one draws from them. If I could ask the Tribunal to
33 focus first on para.37. Perhaps the Tribunal can read paras. 37 to 38 before I make my
34 submissions. I do not believe these are confidential, but someone will tell me.

1 THE CHAIRMAN: Yes, mine are highlighted.

2 MR. SAINI: Lucky I did not read them! (After a pause) Without stating the figures, I would
3 emphasise to the Tribunal in particular the point made at “c” on p.495 in relation to
4 weighted average cost of capital, and the point at “d” the amount of flexibility that pricing
5 at DSAC gives. So there is no doubt that it permits very substantial flexibility.
6 My next point, which is a point I called “rate of return”, and again I am not sure if it is
7 confidential – those behind me will tell me if I am wrong in this – the point is made by table
8 2 – I am sorry it is not table 2

9 11.45

10 The point is made – and those behind me will tell me if I am wrong on this – by table three
11 which is at p.504 of this bundle. It does not seem to have a confidentiality marking. I am
12 grateful to my friend for saying it does not. Pricing at DSAC clearly allows BT to recover
13 its costs and indeed to obtain rates of return well above the cost of capital. In fact, if one
14 looks at the bottom column there, this is following repayments. One sees that on average
15 we see figures between 47 and 54 per cent. There is a return of about 50 per cent. Please
16 put that against the cost of capital which is 12 per cent, so a very, very attractive rate of
17 return is permitted when one applies DSAC, four times larger than the cost of capital. That
18 is assuming that has taken into account external sales only at the bottom and one sees the
19 more attractive figures if one includes internal and external sales in the middle. On any
20 view, it gives a very, very attractive rate of return.

21 The third point is that it has been very well known since at least 1997 that an approach to
22 assessing cost orientation is to apply a DSAC ceiling and a DLRIC floor. One does not
23 need to do a historical trawl in respect of that point because one can rely upon BT’s own
24 2005 primary accounting documents which summarise very clearly the importance and use
25 of DSAC and DLRIC.

26 It is going to be said against Ofcom I am sure that all of these points about DSAC are fine
27 as far as they go but the moment you start they only work effectively if you approach the
28 question of cost orientation on an aggregated basis. The moment you do that, these figures
29 all look quite good. That takes me to my second main issue which is aggregation and,
30 although it was not developed at length by Mr. Read in his submissions, the issue of
31 aggregation lies at the heart of many of BT’s points in this case. Particularly bearing in
32 mind what Mr. Read said at the end of his submissions yesterday about legitimate
33 expectation, I think it is important to unpick what we understand the case to be against

1 Ofcom. I will try and articulate it in this way and perhaps not now but in due course Mr.
2 Read will indicate to me if it is wrong.

3 As I understand it, BT argues that for the purposes of assessing BT's compliance with
4 condition H3, which concerns trunk charges, Ofcom is obliged to consider the costs of
5 terminating and trunk segments in aggregate. If Mr. Read is wrong in that, then many if not
6 most of his points in this appeal, which we say are premised upon aggregation, disappear.

7 As we understand it, BT put their case in two ways. First of all, it is said that on construing
8 condition H3 – that is, construing it as a matter of law – one has to aggregate trunk and
9 terminating segments. I do not believe that submission has gone and that is why I took the
10 Tribunal yesterday to the conditions. That is one way of putting it. We have a very easy
11 answer to that.

12 The second way of putting it is I think that, by Ofcom's conduct, it created a legitimate
13 expectation on the part of BT that, when considering enforcement of condition H3, BT
14 would be permitted to aggregate terminating and trunk segments. The two ways are, first of
15 all, as a matter of construction of the condition and, secondly, that by Ofcom's conduct we
16 led them to believe, putting it in rather crude terms, and there are two particular matters as I
17 understand it which are said to create that legitimate expectation.

18 One is Ofcom's rejection of the 2004 rebalancing proposal and, secondly, comments made
19 by Ofcom when it closed down the 2005 own initiative investigation into trunk segments.

20 If I can put the legitimate expectation points to one side for the moment and explain our
21 case as to why, as a matter of principle, BT's arguments on aggregation cannot be accepted,
22 we have six separate reasons for that.

23 The first one I can deal with very shortly and that is the interpretation of the cost orientation
24 condition, as a matter of law. This is the point I was making yesterday. If one looks at
25 condition H3 it clearly applies to trunk segments. It clearly applies to two megabit trunk
26 segments. The condition says each and every charge. There is no room for manoeuvre, just
27 looking at the condition itself.

28 The second point is that there has been a determination by Ofcom which has never been
29 challenged that there are two separate markets and, as part and parcel of that determination,
30 two separate regulatory regimes were applied to trunk and terminating. For terminating, the
31 handcuffs were very tight. There was a specific price control. For trunk, there was no
32 specific price control but a basis of charges obligation represented by condition H3.

33 Basically, there are two different rules applying. Putting it crudely, without disrespect to
34 my friend, as we understand BT's case, it is effectively this: that we can "overcharge" on

1 trunk because we are undercharging on terminating. That is what their case is. It also
2 follows from Mr. Read's case that if they wanted for example one day to increase the
3 charges on terminating and then reduce them on trunk they would be okay. The logic of
4 this position is they can increase the prices on terminating to a level which exceeded the
5 price control. There are two distinct conditions, two different forms of SMP remedy
6 imposed to deal with the problems in those two different markets.

7 It is notable, sir, that even BT itself acknowledges that these are two very, very different
8 markets. Can I just ask you to go to BT2, JM4? You were taken to this letter by Mr. Read
9 yesterday. A lot of weight is placed upon this letter. I am going to show you a part which I
10 am not sure you were shown yesterday. I apologise if you were. It may not have been in
11 this context. This is a letter that Mr. Morden refers to in his witness statement. Can I ask
12 you, please, to go to paragraph 13 of the letter, page three of ten? It reads as follows:

13 "Based on the many recorded statements like this, the trunk and terminating PPC
14 markets are clearly seen as very different from each other by Ofcom (and previously
15 Oftel). In order to achieve regulatory objectives different strategies need to be
16 adopted – to tightly price regulate terminating services while using competition or
17 prospective competition to 'regulate' the trunk market."

18 BT itself was recognising there that there are distinct markets and distinct regulatory
19 approaches applied to those separate markets. Running through my list of six points of
20 principle which suggest that aggregation is not appropriate, I am onto my third one now
21 which I will call "economic rationale". I can summarise it as follows: there is no doubt that
22 the individual price charged for a trunk segment will have an effect on a communication
23 provider's purchasing decisions. It is clearly a significant factor and in particular those who
24 buy a higher proportion of trunk segments, which we know some communications providers
25 do, will be significantly worse off than those who do not, who rely for example on self
26 supply.

27 There is a table which I cannot put my finger on at the moment in the determination which
28 sets out the different proportions of trunk and terminating purchases but I will not even try
29 and summarise it because it may be confidential. Perhaps Mr. Mussa or Mr. Segan can
30 identify it for me. It is confidential and it is at p.828 of the determination which is in core
31 bundle two. The introduction to this table at figure 4.1 is at para 4.50. I can perhaps read
32 that and not the table.

33 "Trunk and terminating services are, however, not always purchased together and in
34 fixed proportions, as Figure 4.1 below indicates. This difference in purchasing

1 patterns reflects a number of factors, not least the extent of trunk self-supply and the
2 relative lengths of the trunk circuits purchased by the Disputing CPs.”

3 One sees there is actually quite a substantial variation between the different providers. The
4 point is also made which I do not think is confidential at paragraph 4.51 that the variation in
5 consumption patterns is also reflected in BT’s own circuit analysis, which we will come to
6 in due course.

7 The distinct price of trunk services, we say, is economically meaningful for operators’ make
8 or buy decisions and there is evidence which you will hear in due course from Mr. Harding
9 who is within the Altnets market. It is also worth bearing in mind while we are in the
10 determination, if one goes back, please, just one page to 826 at paragraph 4.43, it is the last
11 part of that paragraph which I would ask the Tribunal to note, which is about seven or eight
12 lines down. We see that on some occasions PPC trunk services are purchased from CPs
13 other than BT.

14 “It was estimated in the 2008 BCMR consultation that non-BT supply of trunk
15 services (i.e. trunk that was self-supplied by CPs or purchased from CPs other
16 than BT) accounted for around 14% of the total PPC trunk market (or 33% of the
17 market when BT’s supply of trunk services to its internal businesses are
18 excluded).”

19
20 There is a separate market for trunk and the prices of trunk are economically meaningful
21 factors for communications for other providers.

22 The fourth point, sir, is what I call “regulatory certainty”. We say that everyone within the
23 industry understood, including BT, that individual services had to be justified as cost
24 oriented, not any aggregated services. We say that flows from both the terms of the
25 condition and from the reporting obligations which BT undertook in the regulatory financial
26 statements which you have seen. BT clearly itself split out these services when reporting.
27 It is at this stage that one needs to consider Mr. Read’s legitimate expectation point. He
28 says it was not certain and in fact, on two occasions, you gave comfort to us that trunk and
29 terminating would be aggregated.

30 The first sort of comfort is said to be the rejection of the rebalancing proposal in 2004. One
31 needs to go to bundle ADB2 for that one and put the determination away. I believe that Mr.
32 Read showed you yesterday tab 4. This is the Partial Private Circuits Charge Control
33 statement of 30 September 2004 which followed the Leased Lines Market Review.

1 Just to explain to the Tribunal where we are in terms of the chronology on this document,
2 we have had the Leased Lines Market Review and it has been determined that, as far as
3 trunk is concerned, there is going to be a cost orientation obligation, condition H3, but for
4 terminating there is going to be a specific price control. This document is concerned with
5 what that specific price control is going to be. It is nothing to do with trunk segments. It is
6 concerned with the price for the terminating part. I believe, unless I am wrong, Mr. Read
7 showed you the summary section at p.7, S.26. I believe he was relying upon the fact that at
8 the bottom of p.7 and S.26 it was said:

9 “In addition, the most up to date accounting information provided by BT indicates
10 that its overall profitability in providing PPC services is currently in excess of its
11 cost of capital and therefore does not provide compelling evidence of a need for
12 increased prices. Therefore, Ofcom is not proposing to revise starting charges for
13 the charge control. This is consistent with the approach set out in the
14 consultation.”

15 I believe he said that this gave some comfort to BT that Ofcom was going to allow an
16 aggregation of terminating and trunk, but he did not show you the more important part of
17 this document which returns to this subject, which is beginning at page 100. Again to give
18 you some context, what BT was doing here was it was basically trying to get an increase in
19 the price at the start of the charge control for terminating segments. In its submissions, it
20 was putting forward two types of document it had prepared. The first was something called
21 the pricing model and the second was a profitability analysis. This was a bid to try and get
22 more money at the start of the price control.

23 Ofcom rejects reliance on both of those documents and ultimately concludes and says to
24 BT, “You have not satisfied us that you need an increase in charges beyond the current
25 prices that were last set.” If I can just summarise the rejection, first of all, at C.12, page
26 102, as regards the first document or type of material put forward which is the pricing
27 model, Ofcom explained:

28 “Ofcom’s review of BT’s model identified a number of specific concerns regarding
29 the robustness of the data and the methodology employed.”

30 Then there are the issues. I will not go through the two issues identified but, because of
31 those two issues, they reject reliance upon that. Secondly, jumping a few pages ahead at
32 105, they look at the second document which is BT’s profitability analysis. One needs to
33 look at these paragraphs with some care. C.28:

1 “In addition to reviewing BT’s Pricing Model, Ofcom has considered whether
2 there is any evidence that current PPC terminating segment charges either are or
3 have been too low such that BT had not been fully recovering costs. At face value
4 the outputs of BT’s Pricing Model would appear to suggest that this is the case.
5 Ofcom considers that this would be reflected in BT’s rate of return.”

6 C.29:

7 “BT provided a financial schedule for 2002/03 in a form that disclosed the
8 profitability of each individual regulated PPC terminating segments service, rather
9 than these being reflected within overall totals for revenues, costs and mean capital
10 employed for the inland private circuit network component.”

11 C.30:

12 “According to this profitability analysis BT disclosed a return on mean capital
13 employed ...”.

14 There are various percentages set out there.

15 “It should be noted that these figures include the results for trunk transmission
16 which is not subject to the proposed PPC terminating segments charge control. As
17 discussed above the reported volumes split between trunk and distribution proved
18 inconsistent with the costs. In the absence of a reliable volume split and
19 recalculation of the transfer charge revenues from BT’s downstream activities,
20 results for trunk transmission have been included in the overall profitability
21 analysis.”

22 Ofcom have not endorsed any aggregation in any respect. It is simply saying, “You, BT,
23 have put forward these figures. The conclusion is C.31:

24 “Based on the above profitability information available to Ofcom concludes that
25 there is insufficient evidence to suggest that BT is substantially under-recovering
26 its costs in terms of supplying PPC terminating segments services to its
27 downstream operations and to the Altnets combined over a sustained period.”

28 Then, at C.32, Ofcom again makes the point that it cannot rely in any way upon BT’s data.
29 There simply is not evidence that it is under-recovering on costs. To draw from C.30 to
30 C.33 or from the earlier paragraphs the conclusion that BT was obtaining some comfort
31 from Ofcom that trunk and termination would be aggregated is, with respect, an impossible
32 submission. What is being said there is that we just do not have enough information
33 because your figures are no good. There is insufficient evidence to suggest that you are
34 under-recovering on terminating. It is important to note that Mr. Read, when he took you to

1 the draft determination yesterday, indicated that somehow Ofcom had agreed that there was
2 an under-recovery on the terminating aspects. Perhaps we should look at that. I believe it is
3 in BT1, tab 4, which is the draft determination. I do not know if Mr. Read took you to these
4 paragraphs, but it is para. 5.21, and again I do not know if the table is confidential – I do not
5 believe it is. It is in particular the paragraph, which I will not read, which is in the third
6 bullet point. After having explained that there appear to be low rates of return on TISBO
7 services at 5.21 Ofcom notes the following, and this third bullet point goes back to those
8 paragraphs we have just been looking at. What is crucial, sir, is the point made there by
9 Ofcom which is that in 2004 Ofcom had been put before it data by BT indicating that its
10 terminating charges were too low. It did not accept that data, it decided not to allow an
11 increase in terminating charges, and BT chose not to appeal that decision.

12 Running throughout the submissions by BT in this present appeal is again the argument that
13 its terminating charges are too low, but that is an argument that it had in 2004, that it lost
14 and it did not appeal. That is at 2004, proposed rebalancing which has said to give rise to a
15 legitimate expectation and we say it is nothing of the sort. We will look at the law in due
16 course, perhaps in closing, but you will recall that the test for a legitimate expectation is a
17 clear and unequivocal representation by the public authority. It is hard to see, with respect,
18 how in the few paragraphs that we have been looking at there was a clear and unequivocal
19 representation by Ofcom that it was going to allow BT and going to require the rest of the
20 world to accept an interpretation of Condition H3 which was different to its ordinary
21 language meaning. That is effectively what is being said, that somehow representation had
22 been made that is going to mean something other than that which it says.

23 The second matter that is said to give rise to a legitimate expectation is Ofcom deciding in
24 2005 to end its own initiative investigation. We can put away the BT1 bundle, and also
25 AD2, and could the Tribunal have BT2 and BT3 available, and in BT3 it is tab 12.4 which
26 is the document that Mr. Read took you to yesterday.

27 There are a few points to make about that document. First, it is clear that the investigation
28 concerned only trunk segments, it did not concern terminating segments. But, when one
29 looks at the body of this document, rather than it supporting BT's submission that this gave
30 comfort to BT that trunk and terminating were going to be aggregated, the bottom of the
31 very first page makes it clear that Ofcom's desired approach was to split the costs between
32 trunk and terminated. If I may read the very last paragraph on the first page:

33 "During the course of the investigation Ofcom identified a number of concerns
34 relating to the accounting treatment of PPC trunk segments. These concerns

1 primarily relate to the way that core transmission costs are split between PPC
2 wholesale trunk segments (which fall within the Wholesale Trunk Segments
3 market and are regulated basis of charges Condition H3) and PPC terminating
4 segments (which fall into the TISBO Markets and are regulated through the PPC
5 terminating segments charge control for low and high bandwidths)."

6 If we just stop there for a moment, BT has been told that the accounting treatment that you
7 have put forward does not appropriately split out the costs for trunk and terminating, that is
8 why we cannot take this any further. That does not give comfort that trunk and terminating
9 are to be considered together, it does the opposite. It is telling them they are to be split and
10 go away and restate your data and split them. Basically the evidence base that was put
11 forward by BT was simply insufficient to permit Ofcom to assess pricing for trunk. The
12 answer to that is that BT were sent away, one sees this at the bottom of the second page,
13 they are sent away "To establish accurate proportions of network components used in PPC
14 Wholesale and TISBO and Trunk Markets."

15 We say it is hard again to draw from this document a clear and unequivocal representation
16 that when Ofcom enforces condition H3 it will allow, contrary to the wording of condition
17 H3 it will allow an aggregation of trunk and terminating costs. It is a huge leap from this
18 document that in fact we say the document suggests the opposite, which is a very real
19 concern on the part of Ofcom that you have to split the two not deal with them together.

20 We have gone slightly out of order here, which is that I had a fourth point, which was
21 regulatory certainty. In regulatory certainty my headline point was that everybody knew,
22 including BT that a disaggregated approach was to be adopted, look at BT's own accounts,
23 which we were looking at this morning. The answer to that would have been the 2004
24 rejection of rebalancing, and the 2005 closure of the own initiative investigation, which
25 according to Mr. Read would send a different signal to BT, in fact, so strong as signal that it
26 creates what he says is a legitimate expectation. We say that neither of those two matters
27 created a legitimate expectation. What happened in 2004 nor 2005 suggested that
28 aggregation was the approach that the regulator was going to adopt.

29 The fifth point of principle, as to why disaggregation is the correct approach is that if one
30 allowed BT to aggregate the two services, it would destroy the incentive, which is built into
31 the terminating segment charge control. What BT's argument comes to is the terminating
32 segment charge control, which it did not appeal, was too low and that this Tribunal should
33 somehow soften the rigour of that control by allowing BT to make up its losses by charging
34 more on the trunk segment.

1 If that argument were permitted it would completely undermine the terminating segment
2 price control, because the idea of the price control is that an incentive is created on the part
3 of BT to improve efficiency because it will benefit itself in gains from improving
4 efficiency. That incentive is completely undermined by allowing it to make up for claimed
5 losses through the trunk aspect. Indeed, the trunk is very well made by the Altnets' expert
6 witness, Mr. Ridyard, and I will just give you a reference to that, it is para.15 of his report.
7 Sir, I said I had six points, I actually realise coming to the end of them I only had five points
8 of principle which I am sure will not disappoint anyone!

9 That is the second part of part 4, which is the more detailed consideration of four particular
10 factors, the first having been DSAC, the second – aggregation, the third I am going to turn
11 to is combinatorials, which features very heavily in this case.

12 The starting point, sir, you will recall BT's own words that one of the purposes of DSAC is
13 to avoid the need to use combinatorials. This is in BT's primary accounting documents we
14 saw in additional bundle 4. However, Ofcom did not close its mind to the availability of
15 combinatorials and indeed was willing to hear any submissions that BT wished to make on
16 combinatorials because the 2001 Guidelines, and 1997 Guidelines both say – and you were
17 taken to this yesterday by Mr. Read that DSAC will be a first order test but you might also
18 be able to supply a set of combinatorials based upon stand alone cost, but crucially, and this
19 is a quote from the Guidelines, they must be combinatorials prepared according to a
20 “generally accepted robust methodology.”

21 There are various points of principle which Ofcom identified which made the use of
22 combinatorials in the present case very difficult, and they are usefully summarised, if one
23 goes to core bundle, the determination, para.5.56(v). That is p.852 of core bundle 2. There
24 are a set of points made there between (a) and (f) which identify the problems in principle
25 which arose in this case in relation to BT's approach on combinatorials. The first point, (a),
26 concerns the need to do combinatorials with:

27 “... every combination of services that includes the service under investigation and
28 that shares common costs.”

29 I am going to come back to that in a moment, but for the purpose of analysis, in my
30 submission, point (b) is the fatal point in this case because you take point (b) first. There is
31 no answer to this, and indeed it appears that BT's witnesses accept that this is a fundamental
32 problem, which is that a failure of a combinatorial in this context does not indicate which
33 service has overcharged. That is a fundamental point of principle, there is no answer to
34 that.

1 There are a series of further points made, but perhaps I can come back to (a) and illustrate
2 (a) by reference to a particular table. I will preface this by asking the Tribunal to look at,
3 staying in the determination, p.857, para.5.69, just to explain the context in which this point
4 arises, and it is a quotation from the text by Baumol, Panzar and Willig, and they say there,
5 if I may read that paragraph:

6 “A robust set of combinatorial tests would separately compare revenue and
7 efficient SAC for each and every combination of services that share common
8 costs.”

9 Then these authors say:

10 *“The requirement that (either) the stand alone or the incremental tests must be*
11 *passed by all subsets of products and services, individually and in combination,*
12 *may seem a mere technical complication, yet it can be crucial.”*

13 So in order for BT to satisfy Ofcom that it was adopting cost oriented prices and to satisfy
14 BT by reference to combinatorials, it had to show that the combinatorials that it undertook
15 included large number of services which shared common costs with trunk segments.

16 If you stay within this document, and if one goes to p.928, and I think these copies may be
17 confidential figures, can I ask the Tribunal, please, to read paras.7.123, 7.124 and that table.
18 (After a pause) I would emphasise in particular the percentage figure which is confidential
19 in the fourth line from the bottom in 7.124. (After a pause) If I can make the point, without
20 stating the figures, there is clearly a very large number of other services which share
21 common costs with 2 Mbit trunk. All of those services have to be included within the
22 combinatorial tests. What is not satisfactory is to merely use the six combinatorial tests we
23 see at the top of the page, because they are pretty uninformative. To get an idea of the
24 ballpark figure of the number of combinatorial tests one would need to do, if one can go
25 back in the determination to p.857, para.5.70 – this brings back memories of the horrors of
26 A level maths, this paragraph, particularly 2^{n-1} – one sees there the number of
27 combinatorials that one needs to do. If you have 21 products sharing a common cost you
28 have got to do a million combinatorials. The number of combinatorial tests increase to over
29 a billion if you got 31 products that share a common cost. You will see that there are a
30 substantial number of services on the confidential table that share common costs with 2
31 Mbit trunk. Clearly there was a very, very substantial number of tests that would need to be
32 done.

33 There was complaint yesterday by Mr. Read that, “You did not tell us, Ofcom, what you
34 wanted us to do, and in fact you only told us that you wanted us to do this in the course of

these proceedings". With respect, he did not take you to the correspondence in which my clients had expressly identified this as a problem well before the final determination. I have this letter in various places, I am just going to make sure I give you the right reference. It is a letter of July 2009, which I believe is confidential, so I will not read it. It is in BT3 at 11.2. Mr. Read was saying that, in fact, BT had not had any proper engagement from Ofcom in relation to the problems that Ofcom now says, or said in the determination, arose in respect of combinatorials. I can take it very quickly, without reading it, if the Tribunal could please look at the second page of that letter. On the first page we deal with the combinatorials presented. On the second page, under the heading "Number and selection of combinations", without reading it, the very point that I am making now was made fairly and squarely to BT before the determination. Can I draw attention to the very last sentence just above the part that says "Cost modelling", I will not read that out again, I doubt if it is confidential, but that is just simply a repetition of what is in the 2001 guidelines, which is that Ofcom is saying to BT that there may be an answer to this but if you can establish a generally accepted and robust methodology that is the way forward, and it is going to require consultation. We know that the Altnets, when they were faced with BT's combinatorials, made it absolutely clear that they were not accepting them. The points of principle which were problems with combinatorials, which I identified from that page of the determination, we would say, with respect, were not answered by BT's combinatorials, and in particular what was not answered was how does one know when a combinatorial is failed which particular service has caused the failure. In addition to that, the Tribunal will note, and I can just take this briefly by going back to that page of the final determination, p.852, where the summary was provided of the problem with combinatorials, there were further problems of principle identified between (c), (d), (e) and (f). So it is not surprising, sir, that BT in its primary accounting documents, which we looked at this morning, when it referred to DSAC was saying that DSAC effectively replaces the need to do combinatorials because there are fundamental problems of principle. What you will note, however, when you look at those documents again, the primary accounting documents, is that as far as core was concerned, which is where partial and private circuits lie, it has been made clear that DSAC is the test because combinatorials have not been specified. Going on in that document, for other aspects of BT's business, in particular the access increment, combinatorials have been specified, no doubt because there is a generally agreed

1 and robust methodology. But for the core and for PPC in particular they have not been
2 specified.

3 We say that Mr. Read is quite unfair in portraying my clients as closing their minds to
4 combinatorials. In fact, they were very receptive to any combinatorials, but they laid out for
5 BT the problems of principle that arose and invited BT, if they could, to answer them, but
6 they did not.

7 MR. READ: With respect, he has not take you to all the correspondence and there is a letter from
8 BT responding particularly to the concerns expressed in that point. I think it is wrong to say
9 they did not put their concerns back. They certainly did. There is obviously a dispute as to
10 how valid or otherwise the concerns actually are. It is in tab 11.1 of the bundle that you
11 were taken to.

12 MR. SAINI: It is confidential, I think, it is 13th July – is that the letter?

13 MR. READ: The letter that my learned friend took you to was, as I understand it, 15th July letter.
14 Unfortunately it is in, if I can call it, solicitors' chronological order, in that the reply is then
15 in the tab earlier, which is 11.1, which is a letter of 7th August 2009.

16 THE CHAIRMAN: We will make sure we read that.

17 MR. SAINI: Sir, all I will say, I did not want to take an unfair point, but if one actually looks at
18 the letter, which the Tribunal will in due course, it does not, with respect, answer the
19 fundamental problem with combinatorials, namely the combinatorials that BT were
20 presenting did not include services that shared the vast majority of costs with trunk.
21 It is important to bear in mind here, sir, where the burdens lay, because BT was constantly
22 saying, both in this correspondence and elsewhere, that it is up to Ofcom itself to do
23 combinatorials or to set out which combinatorials BT should do, but the burden of
24 demonstrating compliance is on BT. That is not a point that I am making now, it is a point
25 that was made clear in the determination. Can I ask you to go to p.859 of the determination
26 in core bundle, which you may still have open. I do not know if the quotations at 5.76 and
27 5.77 from BT's letters are confidential, but I will not read them. They do not seem to be
28 confidential. Given that the underlying letters may have been I will not read them. One
29 sees what BT was saying in 5.76 and 5.77 as to what Ofcom should have done. Then if I
30 may read 5.78:

31 "Ofcom disagrees with this statement. The cost orientation obligations place a
32 clear requirements on BT to '*secure, and ...be able to demonstrate to the*
33 *satisfaction of Ofcom*' that each and every charge is cost orientated. Where a
34 charge breaches what BT's own PAD ..."

1 that is a document that we saw this morning –

2 “... refers to as ‘*the maximum charge hat can be charged*’, but BT still believes
3 that the charge is reasonable, the onus is therefore on BT to demonstrate that the
4 charge is reasonable, rather than for Ofcom to prove that it is not.”

5 So we have a position, sir, where DSAC is exceeded when BT, itself, has described DSAC
6 as the maximum charge that can be levied, it is surely then for BT to come with evidence to
7 explain why, despite exceeding DSAC, Ofcom should find that it had not overcharged.
8 The members of the Tribunal will recall yesterday that the terms of condition H3, which
9 imposed a burden upon BT, and those provisions come from the Directive. It was for BT to
10 produce the evidence.

11 What BT should have been doing, sir, is year after year its DSACs or 2 Mbit trunk were
12 being exceeded. For the other trunk segments the position was different, but on many
13 occasions exceeded.

14 BT, itself, knew that that was a first order test of cost orientation. If BT was complying
15 with its regulatory obligations it should have had in its files some evidence of combinatorial
16 tests or some other evidence that established to its satisfaction, and then to the satisfaction
17 of Ofcom, that despite the fact that we are exceeding what we call a maximum charge, we
18 are content that we are not overcharging because, for example, on the vast majority of other
19 services we are under-recovering costs. So it is really for BT to do that.

20 What Mr. Read has sought to do is turn the tables. This is symptomatic of BT’s approach to
21 this case, because they would like this to be a case where we are alleging a violation of
22 competition law, where we face all the burdens. We do not. We have established in this
23 case that BT’s charges exceed what it calls the maximum charge. It is then for BT to bring
24 forward evidence as to why, despite that, there has been no violation of cost orientation
25 obligations.

26 One of the ways of doing that would have been combinatorials. The combinatorials they
27 presented fell far short of what was required, even if in principle they could be satisfactory.
28 Sir, I am coming to the last of my four heads under ground four which is economic harm.
29 What is said against us and was said again and again yesterday by Mr. Read is that we have
30 effectively treated DSAC as a pass/fail test and done nothing else. With respect to
31 Mr. Read, that ignores what is said in a large part of the determination. The determination
32 does not just stop after finding that there has been pricing in excess of DSAC. Ofcom in
33 some detail considers the issue of economic harm. Can I ask the Tribunal to go to p.908 of
34 the determination, para.7.32. This is not just a question of a paragraph deciding that there

1 had been economic harm. There is a detailed consideration of the question of economic
2 harm in accordance with the Guidelines. What is crucial, sir, is that the Guidelines,
3 themselves, say not that Ofcom must be satisfied that economic harm has, in fact, occurred,
4 but you will note that they refer to the likelihood of harm – in other words, whether there is
5 a potential to cause economic harm. One sees that at 7.34 and 7.35. One has to look at this
6 through different spectacles to those which would have applied or been worn in 2001,
7 because in 2001 we did not have an SMP condition. In 2010 and 2009 we have an SMP
8 condition where it has already been decided that the public interest, in particular the
9 protection of BT's customers and ultimate consumers, protection from unfair pricing
10 demands and conditions, therefore, there has already been a judgment made that, absent that
11 condition, there will be economic harm. But what Ofcom has done at 7.36, which it then
12 goes on to expand, is it identifies the main sources of likely harm. There is going to be a
13 dispute on the evidence, and in some ways more of a dispute between the CPs and BT than
14 between Ofcom and BT, as to the extent or the amount of harm that may have been caused.
15 We say that, as a matter of principle, one cannot doubt that the types of harm identified at
16 7.36(i), (ii) and (iii) are likely to have flowed from excessive pricing.

17 It is said against us by Mr. Read, and indeed by Professor Yarrow and Dr. Decker, that all
18 of these sources of harm proceed on the assumption that pricing above DSAC is excessive
19 pricing. It was put yesterday as one of those cases where one is assuming what one needs to
20 prove.

21 But if DSAC is a first order test, then failing DSAC must have a consequence. Failing
22 DSAC gives rise to, at the very least, a presumption that there has been an over-recovery of
23 common costs. It has to be given some weight. If it is given no weight then it is not a first
24 order test, it is not any test at all.

25 It would have been open to BT to say, "Okay, we failed DSAC, we start with the
26 presumption that there has been over-pricing, but there are these 15 factors which indicate
27 that, in fact, there is not any harm – combinatorials, circuit analysis, low price of
28 terminating". It is open to them to say that. What they cannot argue with is that if DSAC is
29 to be a meaningful test at all it must give rise to some kind of presumption.

30 We know, sir, in particular, and I do not believe this is a point which is disputed from the
31 evidence, as far as I can see, although it is principally a matter of dispute between the
32 Altnets and BT, which is that Mr. Harding gives evidence that the price of trunk services,
33 and particularly the excessive price of trunk services, feeds directly into the day to day
34 decisions that CPs make. We know that if I am a communications provider that does not

1 need to use very much trunk because of the way my system is configured, I can, for
2 example, bid for a contract with a retailer that wants to have connections at a much lower
3 price than someone who needs more trunk in order to bid for the same service.

4 It is not rocket science, it is, in a sense, obvious that a high price in trunk will have an
5 economic impact. So it is not a high hurdle to overcome.

6 Sir, I believe I have just about concluded my submissions. I will need perhaps 15 minutes
7 more. Would that be a convenient moment.

8 THE CHAIRMAN: Yes, that would be, Mr. Saini, we will resume at two o'clock.

9 MR. SAINI: Thank you very much, sir.

10 (Adjourned for a short time)

11 MR. SAINI: Sir, I wanted to conclude my submissions just by making a few points in relation to
12 the issue of repayment. Can I first of all please ask you to turn up bundle DF4 and to look
13 at the relevant section of the statute which is in tab 5, p.29, which will take one to section
14 190 of the Communications Act 2003? This applies to resolution of disputes. (2) of 190
15 sets out the remedies or orders that are available to Ofcom. If you would please go down to
16 (2)(d), Ofcom can:

17 "For the purposes of giving effect to a determination by OFCOM of the proper
18 amount of a charge in respect of which amounts have been paid by one of the
19 parties of the dispute to the other, to give a direction, enforceable by the party to
20 whom the sums are to be paid, requiring the payment of sums by way of
21 adjustment of an underpayment or overpayment."

22 What Ofcom did in this case is that, having decided that DSAC was the right charge – and
23 that is setting an upper limit – it decided in all the circumstances to exercise its discretion to
24 require a repayment. However – and the Tribunal may not be aware of this – this was
25 something which was deeply unpopular with the communications providers because they
26 said that DSAC did not set the appropriate charge. They said the charge in fact should have
27 been less than DSAC. Ofcom had to conduct a balance between its own view of what the
28 right level of the charge was, which is the charge set by DSAC, and what the
29 communications providers were saying.

30 Perhaps I can just draw this to your attention, sir, back in core bundle 2, the determination,
31 at page 944, so that you can see the argument being put by the Disputing CPs. It is perhaps
32 best summarised in paragraph 8.53:

33 "In their view" – that is, the view of the Disputing CPs – "the DSAC is the
34 maximum price that BT could have charged for 2Mbit/s trunk services. By

1 limiting the level of repayment to the difference between BT's actual charges and
2 the DSAC, Ofcom is leaving BT in no worse a position that it would have been in
3 had it not overcharged the Disputing CPs. This, they contended, provides a weak
4 incentive for BT to comply with regulatory requirements in future."

5 Effectively, what the Disputing CPs were saying is do not just make BT disgorge the level
6 of the overcharge but make them disgorge more than that. The benchmark that they were
7 saying to set the level of disgorgement one sees at 8.55 which is a fully allocated cost.

8 Yesterday, Mr. Read began his submissions by saying that this was effectively a sanction or
9 a penalty, this repayment that was imposed upon BT, but in fact one sees, going back over
10 the page to 945, 8.62 and following, Ofcom considered it could not acceded to the
11 Disputing CPs' request because that would be to penalise BT. It was not appropriate within
12 the scheme of section 190(2)(d) which you have just seen to penalise them. That section
13 made clear that, if there was to be a repayment, it should only be by reference to the proper
14 amount of a charge. Ofcom carefully directed itself here and made a decision which was
15 unpopular with the Disputing CPs. That having been said, sir, a lot is made in BT's
16 submissions about the fact that this was effectively a windfall for the CPs because they had
17 probably passed on the costs of this to their ultimate consumers. Whether or not that is the
18 position, BT's submissions are effectively one sided. How do they explain the fact that they
19 have had over £41 million of revenue when they should not have had? What justification is
20 there for them to keep that money? There is not any justification because if we have
21 reached this stage in the analysis they have overcharged, pocketed over £40 million. By
22 what process of justice do we have an end result where they keep that money? It would be
23 a surprising position.

24 One argument that BT did make to explain why they should keep the money is that they
25 took comfort from what had been said in the rejection of the rebalancing in 2004 and what
26 was said in 2005, the own initiative investigation. You have heard my submissions about
27 that this morning. Ofcom made the position very clear in that regard. If you please go to
28 8.79 at p.948, we say what is said there is amply justified by the documents which we have
29 looked at this morning. If I may read it:

30 "As we have set out in Section 4 above, we do not consider that any of our
31 statements or decision in 2004 or 2005 should have given or actually gave BT any
32 comfort that we had concluded that BT was not overcharging. We rejected BT's
33 rebalancing proposals and closed our investigation into trunk prices on the basis of
34 BT's inability to provide us with the information necessary to make a full and

proper assessment in each case. BT has been responsible for setting trunk charges and had an obligation to ensure that its charges were cost orientated.”

There is a reference to the *National Grid* case which my friend may or may not rely on in due course. The conclusion was at 8.80 that this was not a punishment requiring repayments; it is simply requiring them to return to the Disputing CPs the amounts that those Disputing CPs would have had or kept if there had been compliance with the cost orientation obligations. Sir, I am sorry I have gone on a bit longer than I intended.

THE CHAIRMAN: That is very helpful, Mr. Saini.

MR. SAINI: Unless you have any questions, those are my submissions in opening.

MISS ROSE: Sir, I hope to be significantly more brief than was suggested in the timetable since the CPs gratefully adopt the submissions that have been made by Mr. Saini on behalf of Ofcom. I will endeavour not to repeat those submissions now. We agree with Ofcom that the right starting point for the analysis in this appeal is the 2004 decision on the Leased Lines Market Review and the statutory functions that were performed by Ofcom when it undertook that exercise. Mr. Saini has shown you this morning the provisions in the 2003 Act, essentially from sections 78 down to 88 of that Act, which identified the functions that Ofcom performed when conducting the market review, first of all to identify the individual markets; secondly, to make findings as to whether any undertaking had significant market power in the markets that had been identified and, thirdly, where significant market power had been found, to identify the necessary and proportionate and appropriate SMP conditions to be applied in each individual market to protect consumers and to protect competition. We stress that under both section 88 and section 3 of the 2003 Act, when setting the cost orientation condition on BT, Ofcom was obliged to do so in a manner that was proportionate and that was appropriate to protect consumers. The form of condition H3, unchallenged and unappealed by BT, is to be taken conclusively to represent the necessary and proportionate regulatory exercise to protect consumers against harm in this market, given the degree of SMP that BT had.

The Tribunal can see that a carefully nuanced exercise was being undertaken by Ofcom in that process because Ofcom carefully distinguished between the terminating segment market, in which an actual price control was considered to be proportionate, and the trunk segment market, in which Ofcom concluded that there was not a need for a price control but that cost orientation would be sufficient.

Mr. Saini has shown you in some detail the nature of condition H3 itself. If we can just quickly turn back to it in ADB2, tab 3, page 480, we identify the following features of

1 condition H3 as being salient. First, that the onus is on the dominant provider to secure and
2 be able to demonstrate to the satisfaction of Ofcom that cost orientation is being undertaken.
3 As Mr. Saini showed the Tribunal, that is in accordance with Article 13 of the Access
4 Directive. Second, that the cost orientation requirement applies to each and every charge
5 offered, payable or proposed. We submit that any submission that it is appropriate to
6 consider whether there has been an overcharge on an aggregated basis, even between
7 individual charges within the trunk segment, would be doomed to fail because, even if you
8 are only looking at the trunk segment market, the requirement is that each and every charge
9 offered, proposed or paid must be cost oriented.

10 To suggest that there is any tenable interpretation of condition H3 which not only permits
11 but, on Mr. Read's submission, requires Ofcom to aggregate charges in the trunk segment
12 market with charges in a completely different market, the terminating segment market, in
13 order to determine if there is an overcharge, we submit, is simply contrary to the wording of
14 H3.

15 The third point is that the nature of the cost orientation that is required is that the charge
16 must be reasonably derived from the costs of provision based on a forward looking, long
17 run, incremental cost approach and allowing an appropriate mark-up for the recovery of
18 common costs and an appropriate return on capital employed.

19 We are told very clearly that, when looking at cost orientation, you look at LRIC with an
20 appropriate mark-up for common costs and an appropriate return on capital. Essentially, in
21 order to succeed, BT must persuade the Tribunal that Ofcom's approach falls outside the
22 scope of the words "an appropriate mark-up for the recovery of common costs."

23 Essentially, the whole of the dispute is whether or not Ofcom's methodology can be
24 considered to be an appropriate mark-up for the recovery of common costs. We submit that
25 BT fails to establish that it is not.

26 Sir, that is condition H3 itself. We make two key points about it. First, that BT's
27 complaint, even looking at H3 itself in isolation and ignoring all the material that Mr. Saini
28 has shown the Tribunal today about what BT actually knew, given the terms of H3 itself, it
29 simply is not open to BT to contend in this Tribunal that BT was unaware that the question
30 whether it was overcharging for trunk would be considered alone and not in aggregation
31 with terminating segments. Secondly, it cannot argue that this was not going to be done on
32 the basis of LRIC with an appropriate mark-up for appropriate common costs, because that
33 is clear on the face of the condition.

1 A consideration of the 2004 Leased Lines Review we also submit reveals that other points
2 taken by BT yesterday were bad ones. It was suggested by Mr. Read yesterday that BT was
3 entitled to rely on a finding made by Oftel in 2001 to the effect that the trunk market was to
4 be considered to be prospectively competitive and that, on that basis, BT was entitled to
5 expect a broader scope when setting charges for trunk services.

6 Mr. Read relied for that on documents produced by Oftel in 2001, including the March 2001
7 direction, which is at BT3, tab 12.8. If we go to paragraph 2.6, p.18, Mr. Read yesterday
8 pointed to this paragraph in which Oftel acknowledged that not all PPCs were terminating
9 segments and, in relation to the competitive trunk, Oftel notes in its August consultation
10 document it has, subject to consideration of consultation responses, defined this market as
11 being prospectively competitive. Then Oftel refers to paragraphs 1.33 to 1.36 above which
12 set out Oftel's approach to cost orientation.

13 If we go to 1.33 which is the paragraph there referred to, p.16, Mr. Read relied on this
14 paragraph:

15 "Oftel's view is that the appropriate interpretation of the requirement for prices to
16 be cost orientated cannot be considered in isolation from the extent of competition
17 for the service in question. For example, if the provision of the service in question
18 was effectively competitive or moving towards a competitive market structure,
19 Often would interpret the requirement for cost orientation as meaning any price
20 between LRIC and stand alone costs ceiling, subject to any relevant combinatorial
21 or non-discrimination test being satisfied. If by contrast the relevant economic
22 market was not effectively competitive, then Often would be inclined to interpret
23 the cost orientation requirement to mean that prices should be set on a LRIC basis
24 with some allowance for common cost recovery."

25 Pausing there, the Tribunal will note that there is a strong parallel between the wording of
26 condition H3 and the last part of that paragraph, that prices should be set on a LRIC basis
27 with some allowance for common cost recovery. That is very close to the formula for cost
28 orientation at condition H3. It is a stricter test. There is a very good reason for that and that
29 is that, although Oftel expressed the view that the trunk market was prospectively
30 competitive, when Ofcom undertook its market review in 2003 and 2004, it concluded that
31 the trunk market was not competitive, that BT had SMP in that market and that BT's SMP
32 in that market would continue at least for the duration of the price control which it was
33 intending to fix. If we can just take a look at that, it is at ADB2, tab 3, p.338. This is from
34 annex B to the Leased Lines Market Review. This is a section in which Ofcom reviewed

1 the market for wholesale trunk and analysed the question whether it was competitive. The
2 analysis goes all the way down to p.354. Ofcom concludes that the market is not
3 competitive. The Tribunal can see that conclusion at paragraph B.171 at p.354.

4 On the same page at the bottom, 174, “Likelihood of competition developing in the future”:

5 “Ofcom has considered the potential impact of external factors on this market
6 during the period covered by this review. Ofcom’s view is that there are no
7 developments that would generate sufficient competitive pressures within the next
8 2-3 years to alter the current finding of SMP. This is because the sources of SMP
9 are high structural barriers to entry and because demand conditions and
10 technological progress are unlikely to be able to reduce the strength of these entry
11 barriers in the near future. However, Ofcom will keep market conditions under
12 review.”

13 Mr. Read’s suggestion that BT could draw any comfort from Oftel’s view expressed in
14 2001 that the trunk market was prospectively competitive and for that reason expect cost
15 orientation to be judged on the more relaxed standard at paragraph 1.33 of the 2001
16 document is plainly bad when one considers the conclusion reached by Ofcom in 2004,
17 which was that this market was not competitive and was going to continue not to be
18 competitive for the period covered by this review.

19 As we have seen, that is then reflected in the wording of H3 itself which clearly adopts the
20 stricter test identified at paragraph 1.33 of the Oftel document.

21 The next topic I want to deal with is the question of the alleged under-recovery of costs on
22 terminating segments. It was asserted by Mr. Read at the outset of his submissions
23 yesterday morning that Ofcom had conceded, in the draft determination at paragraph 5.21,
24 that BT did not earn a reasonable return from terminating segments. We looked at that
25 provision before lunch. It is in BT1, tab 4, p.67. this was a crucial part of Mr. Read’s
26 submissions, one of his six allegedly conceded points, and it is central to his argument
27 because we agree with Ofcom that, when you clear aside a lot of the accumulated lumber,
28 essentially BT’s complaint in this case is that they say they have under-recovered on
29 terminating segments and therefore they ought to be permitted to over-recover their costs on
30 trunk. That is their essential argument in this case. Crucial to that is the assertion made by
31 Mr. Read that Ofcom had conceded that they were under-recovering on termination. Mr.
32 Read made that assertion by reference to this paragraph, 5.21, but did not take the Tribunal
33 to it.

1 We submit that when you read 5.21 it is quite obvious why he did not take the Tribunal to it
2 because not only is it not a concession of the point; it is a clear, detailed rejection by Ofcom
3 of that argument. The sentence upon which Mr. Read relied was the sentence at the outset
4 of 5.21:

5 “The rates of return earned on low bandwidth TISBO services are generally very
6 low. Whilst we acknowledge BT’s view that it appears not to have earned a
7 reasonable rate of return on these services, we would note the following ...”.

8 Even if you ignore everything that follows, that sentence is not a concession. It simply says
9 that they acknowledge it is BT’s view that there appears to be not a reasonable rate of
10 return. That is a very long way indeed from being any concession that that is the position.
11 Even putting his case at its highest, this paragraph does not support the submission that Mr.
12 Read made. When you the read that together with the bullets which Mr. Saini showed to
13 the Tribunal this morning, the point becomes wholly untenable because it becomes clear
14 that what Ofcom is actually saying in this section is that Ofcom set the rate of the charge for
15 a TISBO in the 2004 Leased Lines Review. It did so after full consideration of its statutory
16 functions and duties and BT chose not to appeal.

17 In those circumstances, it simply is not open to BT now to argue that it is under-recovering
18 its costs from those charges. Indeed, Ofcom makes the point in the last bullet point at p.68
19 that if during the course of the charge control period BT felt the price caps imposed on
20 TISBO were such that it was unable to recover its costs, the appropriate course of action for
21 it would have been to ask Ofcom to consider whether the charge control remained
22 appropriate. Although BT did suggest in the course of the 2005 trunk investigation that if
23 trunk prices were to be reduced then the price cap may need to be revisited, it did not make
24 any formal approach to Ofcom to request that they revisit the charge control. Low returns
25 on TISBO services do not justify setting trunk charges which are not fair and reasonable.
26 That remains the position. BT never asked Ofcom to revisit the charge control and never
27 sought to appeal it. The question whether the charge control applied to terminating
28 segments was appropriate, reasonable and proportionate is not a question that is before this
29 Tribunal now.

30 In those circumstances, we submit that BT’s argument, with respect, collapses because it all
31 depends on an assertion of an under-recovery on TISBO which it is simply not open to BT
32 to make.

33 It is worthwhile recalling the painstaking process that Ofcom undertook when setting the
34 level of the charge control for terminating segments in 2004. If we go back to vol. ADB2,

1 tab 3, para. 6.106, p.125. In this passage Ofcom considered whether a price control, both
2 interim and long term on the termination segments was justified and identified the
3 arguments for and against, and I just invite the Tribunal to read down to 6.111. (After a
4 pause) You can see that Ofcom consider carefully whether a charge control is necessary at
5 all or whether costs orientation will be sufficient, and they conclude that cost orientation is
6 not sufficient at 6.107. Then at 6.108 they point out that the benefit of the charge control is
7 to give BT the incentive to be more efficient, and then they discuss the level of the price
8 control and the potential adverse consequences of setting it too tightly. So all of these
9 issues were carefully considered at the time.

10 They also specifically considered the statutory tests (paras. 6.127 to 6.130). There is
11 careful consideration by Ofcom of its statutory duties under s.47 and s.88, and why this is a
12 proportionate remedy. All of this was, of course, never challenged. This was the interim
13 price control that was set at the time of this document. Then in September of the same year
14 (30th September) the final decision for the charge control was published, that is in the same
15 volume at tab 4. If we go to p.3 of that document, in the summary, paras. S.1 to S.3 there is
16 the explanation that there is an interim charge control applied by the final statement of the
17 review, and that this document deals with the longer term terminating segments charge
18 control and the intention is said to be that it will “give stability in the markets for PPC
19 terminating segments and encourage BT to reduce its costs of provision leading to the
20 efficient supply of these services.”

21 Then the duration of the charge control was expressly considered, and you see that over the
22 page at p.4, the heading “Duration”.

23 “The PPC terminating segments charge control will have a duration of four years,
24 as this will provide stability ... and increase incentives on BT to achieve
25 efficiency savings.”

26 And then there was discussion about whether you should have a different period and they
27 say four years is the right period. And the detail of the argument on duration in the same
28 document, paras. 2.18 to 2.21 at p.18.

29 Then consideration of the statutory tests again, paras. 5.51 to 5.58 at p.57 and, as you have
30 already seen this morning, express consideration of BT’s proposal to rebalance (where what
31 they wanted to do was raise the amount charged for terminating segments, and they were
32 offering a corresponding reduction in trunk) expressly rejected by Ofcom because BT had
33 failed to demonstrate that it was not recovering its costs on terminating segments.

1 We do submit that essentially what is happening in this appeal is that BT attempted to
2 persuade Ofcom in 2004 that it was not being permitted to charge a sufficient amount for
3 terminating segments. That argument was rejected by Ofcom in 2004 because BT had
4 failed to substantiate it. BT did not appeal that but now seeks to recycle that argument in
5 this appeal now as a justification for overcharging on trunk segments, and we submit that is
6 wholly impermissible.

7 Annex B to this document, p.87 - that is the forecasting model which Ofcom used to derive
8 X, which is the amount each year by which BT was required to reduce charges within each
9 charge control basket, so that was the driving factor, which was going to drive down BT's
10 annual charges for terminating segments. Again we make the point: never appealed,
11 We submit that it is abundantly clear from the 2004 decisions: (i) that trunk and terminating
12 segments are separate markets, (ii) that BT has been found to have SMP in both of those
13 markets. (iii) that separate and different SMP conditions were considered and imposed for
14 each of those markets, (iv) that the rationale for either cost orientation or charge control in
15 each market was separately considered and dealt with in relation to each market, (v) that
16 BT's argument that it was under recovering for terminating segments was considered at the
17 time and rejected. (vi), and this follows from the materials shown to you this morning by
18 Mr. Saini, that Ofcom considered that BT was probably overcharging for trunk in 2004,
19 identified that fact as part of its analysis of SMP and warned BT that there would be an
20 investigation of that question if an evidenced complaint was made to Ofcom – the very
21 opposite of comfort being given there. Finally, that it would wholly undermine the
22 intention and effect of the 2004 statements to aggregate consideration of trunk and
23 terminating segments in order to determine whether BT was overcharging trunk.

24 The claim was made by Mr. Read yesterday – on a different topic – that the disputing
25 communications providers, when they sought to raise a dispute about the level of charge for
26 trunk, based their complaint on an aggregated analysis. Again, we submit, with respect to
27 Mr. Read, that he has misread the documents. If you go to BT 1 tab 6, para. 1.8 on p.3 the
28 communications providers make the point that:

29 “Ofcom and its predecessor, Oftel, have consistently found problems with BT's
30 attempts to calculate the costs of the relevant constituent elements of PPCs and
31 this dispute needs to be considered against that background.”

32 This was a situation, as the Tribunal has seen, Ofcom's own initiative investigation had
33 come to an end because BT was unable to explain how it had attributed costs as between

1 terminating and trunk segments, and the same point is being made here about the difficulty
2 of understanding BT's accounts.

3 Then at 2.15, p.11 the CPs identify the absence of detailed and disaggregated cost
4 information about BT's actual costs in connection with the low bandwidth TISBO, high
5 bandwidth TISBO and trunk products, and they say in the absence of that material they
6 base their claims on an assessment of the true returns made by BT's PPC business. So the
7 CPs are in a position where they simply do not have the information about disaggregated
8 costs.

9 Then at paras. 2.80 to 2.90 starting at p.30 they review alternative methods of addressing
10 the dispute and at 2.81 they say: "We consider two scenarios" and the first of those is that
11 BT is over recovering on trunk, and under recovering on terminating segment markets, the
12 second is that BT is over recovering on both. Then at 2.82 they discuss the two possible
13 approaches of aggregation or disaggregation. At 2.82.2 they say:

14 "In the case of trunk over-recovery signifies an inappropriate overcharge which
15 should be reimbursed. In the case of terminating, under recovery signifies some
16 combination of (i) failure by BT to achieve reasonable efficiency saving targets;
17 and (ii) unduly harsh starting charges and/or gradient ... Whichever of (i) or (ii)
18 applies, BT should not be allowed to offset losses on terminating segments against
19 over-recovery on trunk."

20 Then at 2.83 and 2.84 they set out arguments for adopting an aggregated or disaggregated
21 position and they finally say at 2.89:

22 "The Operators in Dispute acknowledge that there are strengths and weaknesses to
23 each of the positions articulated above. It is ultimately a matter for Ofcom to
24 determine which approach to follow. However, whichever of the above positions
25 is adopted it implies a significant degree of over-charging by BT in breach of the
26 relevant SMP conditions."

27 So essentially the CPs were saying "we do not have the information on disaggregated cost,
28 here are some arguments about doing it aggregated or disaggregated and we leave it to
29 Ofcom to decide which is the appropriate method." Ofcom decided then to approach it on a
30 disaggregated footing, and the communications providers confirmed their agreement with
31 that approach, and that is in BT1, tab 5.2, this is 2nd June 2009 response of the complaining
32 CPs to the draft decision. At 1.2 you can see it says:

33 "In particular the Altnets support Ofcom's assessment of cost orientation at a
34 disaggregated level. This approach is one of a number of possible approaches

1 suggested in the original dispute submission, is consistent with the SMP cost
2 orientation which relates to “*each and every charge offered*” and, as discussed in
3 the annexed RBB Report is the most apt methodology to ensure compliance by BT
4 with its regulatory obligations.”

5 So again we submit it is simply not correct factually for Mr. Read to suggest that the CPs
6 never proposed dealing with charging on a disaggregated basis.

7 Turning to economic harm, Mr. Read repeatedly in his submissions yesterday confused the
8 question of economic harm arising or likely to arise from excessive pricing with the
9 question of loss suffered by the communications providers. Those are completely different
10 concepts. The loss suffered by the communications providers at the simplest level is that
11 they have been overcharged by BT unlawfully levying charges in breach of condition H3,
12 and so at the simplest level their loss is the amount of the overcharge. Now, there may well
13 be further consequential losses including adverse impacts on particular CPs who have been
14 disadvantaged in competition because the configuration of their networks meant that they
15 need to buy more trunk than other CPs, but those losses are not dealt with at all by the
16 remedy that Ofcom has provided. Economic harm is a different question, it is a question of
17 what are the distortions to competition and the adverse effects on consumers arising out of
18 overcharging in the trunk segment.

19 On that point, we respectfully endorse what has been said by Mr. Saini. In particular he
20 showed the Tribunal the table in the determination which shows the variable proportions in
21 which different communication providers provide by trunk. There are reasons for that
22 because different communications providers have very different kinds of networks. For
23 example, Virgin has a network which is a descendant of cable TV franchises. So it has a lot
24 of cable running down individual streets near to particular homes and businesses, but the
25 network is concentrated in particular urban areas where there were cable TV franchises.
26 That means that there may be situations where Virgin does not need to buy PPCs because it
27 can connect directly from its network to business premises. But if it is looking at businesses
28 that have sites in areas where it does not have what used to be a cable TV franchise it may
29 need to buy a long circuit including a lot of trunk because it does not have a network in that
30 area. By contrast, Cable & Wireless ----

31 MR. READ: Sir, I do not want to be too formulistic about this, but I would point out that actually
32 none of the witnesses have addressed this particular point that you are now being taken to so
33 I say that I am quite happy for my learned friend to develop it *de bene esse*, but I think that
34 the real weight that one can place on it has to be obviously left to argument at a later stage.

1 THE CHAIRMAN: That is fine, but as an example I find it quite helpful.

2 MISS ROSE: Yes, it is simply an example of the obvious distortions in competition. Cable &
3 Wireless have an extensive national network but without the connections to individual
4 businesses, so they would need to buy short partial private circuits largely consisting of
5 terminating segments but much less trunk. So you can see from that single example how an
6 imbalance between the price of trunk and the price of terminating circuits may place Virgin
7 and Cable & Wireless – just as examples – in a distorted competitive situation if they are
8 both bidding to provide services to a multi-site business.

9 THE CHAIRMAN: But as you say the table Mr. Saini took me to this morning shows the
10 disparity ----

11 MISS ROSE: Yes, that shows the varying proportion, but I am trying to seek to put some colour
12 on it ----

13 THE CHAIRMAN: -- you can help by explaining the reason why that might be.

14 MISS ROSE: Yes, but they do not have the same kind of network, they have networks that have
15 different characteristics and, as a result of that, they have differing needs for proportions of
16 trunk and terminating segments to purchase from BT.
17 Finally, Mr. Read urged the Tribunal to look at the big picture, and he said that when you
18 look at the big picture and not at the pixels you find that something has gone seriously
19 wrong. We respectfully agree, but not in the way that he suggests. The big picture is this:
20 BT was charging more than twice as much for a trunk segment as for a terminating segment
21 of the same bandwidth. The terminating segment price, subject to an unchallenged price
22 control, you can see that from BT's price list, this is vol.2 of the Interveners' documents,
23 INT2, tab 2, and tab 2.4, p.18, this is BT's price list for January 2008. Page 18, you see
24 three lines from the bottom, "2M", "Terminating Segment charge (per km p.a.) £46.19,
25 Trunk Segment Charge £102.24". Mr. Read himself said yesterday that there is not really
26 much of a difference actually between a terminating and a trunk segment, they are both the
27 same sort of thing and they share a lot of common cost. So that is the first big question
28 mark.

29 The second big question mark is that over a period of years the charge for the trunk segment
30 exceeded the DSAC by an average margin of 180 per cent. This is hardly a marginal
31 overrun over DSAC and we see that in Mr. Myers' witness statement, core bundle 2, tab 18,
32 p.502. This is an analysis of BT's price of 2Mbit trunk compared to DSAC and FAC for
33 comparison. The third line in bold "Price as a percentage of DSAC" you can see it for the
34 various individual years, and the average for 2005/6 to 2008/9 is 181 per cent. You can see

1 on the same table that that is on average 334 per cent of the fully allocated costs; vastly
2 exceeding the fully allocated costs. We make the point that Mr. Saini has made that the
3 DSAC measure is very generous to BT, because it only distributes the stand alone costs
4 amongst services in the core network, and in fact many services outside the core network
5 also share those costs, and using DSAC in fact allows BT to over recover its costs about 100
6 per cent. We see this from the comparison here between FAC and DSAC and the cost
7 contribution from DSAC is even higher than that, that is the table that Mr. Saini showed you
8 this morning, para. 37(b) with the confidential figures. As he also showed you the rate of
9 return on capital from DSAC is 54 per cent, that is at p.504, table 3.
10 We submit that when you look at those figures you do indeed, stepping back from it and
11 looking at the big picture, say: "Something has gone seriously wrong here" because what
12 those figures show is a gross over charge by BT exploiting its SMP over a period of years.
13 Unless I can be of any further assistance those are my submissions.

14 THE CHAIRMAN: No, Miss Rose, thank you very much.

15 MR. READ: Sir, in that case I will call my first witness, who we all know is Mr. Budd. Sir, can I
16 make clear that he has a bundle up there which is a confidential bundle vis-à-vis BT, so in
17 other words it is a bundle that he is entitled to look at vis-à-vis any confidential information
18 as regards BT, but obviously it excludes any other confidential information, for example the
19 interveners' confidential information. I just thought I would make that clear.

20 THE CHAIRMAN: I understand.

21 MR. READ: It is marked so he knows which figures from BT's perspective are confidential.

22 THE CHAIRMAN: Will the witnesses require any assistance with the bundling or will they be
23 able to find the relevant materials?

24 MR. READ: I hope they will be able to find the relevant materials, but I think if any of the
25 witnesses obviously do need help then obviously if they ask at the time, perhaps it is
26 something that everyone can take on board, if they ask at the time and obviously whoever is
27 dealing with the witness can then try and help with finding the appropriate document.

28 Mr. RICHARD MARTIN BUDD, Sworn

29 Examined by Mr. READ

30 Q You are Richard Martin Budd, is that right?

31 A Yes.

32 Q And your address is with British Telecommunications at 81 Newgate Street. Could you just
33 take what is referred to there as core bundle vol.1? Could I ask you to go to tab 10 there?

34 A Yes.

1 Q If you look there, there is a statement which goes through to p.343 and you see that
2 signature there, is that your signature?

3 A Yes, Mr. Read.

4 Q And is that the evidence that you want to adopt in this case?

5 A This is my first statement, correct.

6 Q You adopt that statement as your evidence?

7 A Yes.

8 Q Can I take you on to tab 11 then? Page 344 in the bundle, there is a second witness
9 statement there and at p.368 again that has your signature at the bottom, and again do you
10 adopt that as your evidence in this case?

11 A Yes, I do.

12 MR. READ: Sir, I have no evidence-in-chief to ask, so I will leave him for cross-examination.

13 THE CHAIRMAN: Yes. Mr. Saini?

14 Cross-examined by Mr. SAINI

15 Q Good afternoon, Mr. Budd.

16 A Good afternoon.

17 Q Mr. Budd, if I may first of all deal with the issue of international benchmarking. Is it your
18 evidence that Ofcom did not consider the benchmarking evidence at all?

19 A I believe they put very little weight on that evidence. They seemed to me to say they
20 considered it but then did not put weight on that evidence in coming to their conclusions.

21 Q So you accept they took it into account but your concern is the weight which they attached
22 to it?

23 A They certainly made comments about the evidence we provided, yes, they did.

24 Q You accept they took into account but your complaint is about the weight attached to it?

25 A I think so, yes.

26 Q If we could go in your second witness statement to para. 62, please, the fourth line, but
27 perhaps I will read the whole paragraph to be fair to you:

28 "I note that Mr. Myers quotes Ofcom's last international benchmarking evidence
29 for leased lines and that: '*the results of international comparisons, however,*
30 *should be interpreted with care*'. I agree with Ofcom that such comparisons
31 should be used with care. This is, however, quite different from not considering
32 international benchmark evidence at all, which is the approach adopted by Ofcom
33 in the Determination."

34 Do you stand by that statement?

1 A Well there is a difference between considering evidence then actually taking it into account
2 when you come to your conclusion. You can consider evidence and say I am not going to
3 take that into account any more, but that is the meaning, the meaning there is that it was not
4 a factor which came into consideration at the end of the process.

5 Q So would you accept that when Ofcom says they took it into account, but they gave it
6 limited weight that that was an honest statement by Ofcom?

7 A Ofcom say they gave – I forget the exact word they use, but they clearly put very little
8 weight, if any, on that data.

9 Q Some, clearly?

10 A How much? I don't know how much exact weight they put on it. They did not take into
11 account the fact that BT's charges were in line with those of other countries in any way that
12 I could see.

13 Q Would you accept that there were serious shortcomings in the international benchmarking
14 data?

15 A No, I do not think there were serious shortcomings with the data.

16 Q Well perhaps we can look at it, please, together. If you would kindly take out bundle BT3
17 and go to tab 10.1. I am going to take you to some particular parts of this, I do not know
18 whether the Tribunal has seen it so far but perhaps I had better introduce it. This is a report
19 at tab 1, which I hope the Tribunal has, prepared by Deloitte which is the international
20 benchmarking data, I think this is the only data that is brought forward. We are going to
21 look at parts of this with you, Mr. Budd. Would you agree with me on a threshold point
22 which is that before one looks at international benchmarking data, it is not going to help us,
23 is it, in relation to whether BT's costs justify its charges? It is never going to deal with that,
24 is it? BT's costs as against the charges will never be the subject of any international
25 benchmarking data?

26 A The benchmarking data applies to prices. Some of those prices are derived from other
27 incumbent cost orientation obligations.

28 Q Let us look at BT. It is not going to tell us anything about the justification for the charges
29 that BT advised, because international benchmarking data does not concern BT's own costs,
30 does it?

31 A It is price comparison data, correct, yes.

32 Q Thank you. Let us have a look at what has been done by Deloitte in this report. What I am
33 going to suggest to you, to be absolutely clear, Mr. Budd, is that in fact a comparison is very

difficult because in a large number of cases we simply do not know what the trunk costs are in these other countries. Do you follow me?

A Yes, I recognise that the complete data isn't there for the reason you give.

Q If you will please kindly turn to p.63, which is a helpful table in the appendix, where one sees the detailed benchmarking analysis, if you can read under B1, you will see the last sentence:

“Most countries do not impose price regulation on trunk segments.”

Do you see that?

A Yes.

Q Would you agree with me that only in three countries is there actually a price regulation on trunk segments. That is Ireland, Italy and Portugal?

A It's regulated products in France, it says “trunk segments” – is that one of your three?

Q I just want to ask you the question, which is in which countries – and I do not want you to guess on this and if you do not know and you need to look at it, please do – what I am putting to you is that only in three of the comparator States was there a trunk cost orientation obligation?

A There are more than three here, surely.

THE CHAIRMAN: Take your time and read the table and give an informed answer.

MR. SAINI: Bear in mind I am talking about trunk, not terminating, please. That may help you.

A (After a pause) Well, three countries are, and Spain it says “trunk segments subject to more limited regulation”.

Q Could you identify those for me?

A France, Ireland, Italy, and Spain, “trunk segments subject to more limited regulation”.

Q One sees, for example, on France, right hand column, “Trunk segments are not subject to cost orientation”?

A Yes.

Q Spain, bottom of the page, “Trunk segments not subject to cost orientation obligation”.

A So some have regulation, but not price regulation.

Q Would you agree that when one does not see any price regulation on trunk segments in some of these countries, that makes the reliability of the data as a comparator relatively weak?

A Well, no, because comparing prices with markets which are competitive is especially informative about a regulated market. There is no reason to limit your comparison to only a market which is regulated in the same way. I believe that is actually mentioned in the

1 Communications Act, that it is useful to go to other markets for these kind of benchmark
2 purposes.

3 Q How do we know when there is not a particular cost orientation obligation that there are not
4 some particular factors affecting negotiation of those prices which determine those prices?

5 A Presumably there wouldn't be the price regulation because the market is competitive, which
6 means that you have good a good benchmark in that case. I think that Deloitte's do say that
7 if you have not got the published prices you are not privy to what goes on in commercial
8 negotiation, which may be different from the prices they can see. That's why, in this, I am
9 quite clear that caveats and the benchmarking should be looked at carefully, and not overly
10 interpreted.

11 Q Looking at it carefully suggests that you do not try and identify a comparator which, on
12 analysis, this is not actually a comparator – would you agree with that?

13 A I'm sorry, could you repeat the question, please?

14 Q Does carefully looking at the prices not mean that you have got to be careful in ensuring
15 that what seems to be a comparator is actually a comparator?

16 A You do the best you can with the information you have. You clearly wouldn't use
17 misleading information.

18 Q Is it not also the case, Mr. Budd, that in many countries there simply was no available trunk
19 price. Therefore, what Deloitte's did is they used the terminating charge as a proxy for the
20 trunk price?

21 A Yes, I believe they were transparent in their assumptions, as we asked them to be.

22 Q Does that not rather undermine the reliability of this data because on what basis is it safe to
23 assume that trunk and terminating prices are the same in each of these countries?

24 A It's an assumption that you can carry out sensitivities on, and I notice Ofcom in the final
25 determination did carry out some sensitivities on that assumption.

26 Q Is it not an assumption that if you applied it to the UK it would lead you to completely the
27 wrong result because we know that there is no match between terminating and trunk
28 charges?

29 A The UK has a particular balance of trunk and terminating charges.

30 Q So what warrants the assumption – and we can perhaps help you, if you look at p.67, we see
31 in the rather small print there, and I will just identify the occasions for you because I do not
32 want it to be a memory test for you. If you look at Austria three lines down from the right
33 in Austria it says that there is no price for trunk so they have used terminating as a proxy –
34 do you see that?

1 A Yes.

2 Q Belgium, the same point applies?

3 A Yes.

4 Q Over the page, Germany, the same point applies?

5 A Yes.

6 Q Spain, the same point applies?

7 A Yes.

8 Q Is that not a factor which makes the reliability of this data somewhat doubtful?

9 A Ofcom say that our high trunk charges are illustrative of market power, so if there was
10 competition at the trunk level, subject to taking away regulation, you would expect trunk
11 prices to have been driven down.

12 Q With respect, Mr. Budd, I would ask you to focus on my question. The question was
13 nothing to do with competition, it is a more basic point, which is that if you are using
14 terminating charges as a proxy for trunk charges, that makes the conclusions drawn in this
15 report somewhat unreliable?

16 A It is clear the basis they have been put together, and sensitivities can be worked through on
17 this data.

18 Q Which sensitivities were worked through as far as this was concerned, because I am at a
19 loss to see it either in any representations made by BT or in Deloitte's report?

20 A I believe I wrote about this in my first statement.

21 Q Please take your time. What I am looking for is some account being taken of the potential
22 unreliability of using terminating charges as a proxy for trunk charges.

23 A What I mean by the sensitivity is in para.41 in my first statement on p.320.

24 Q I just need to find your statement. Sorry, you tell me the paragraph number again?

25 A Paragraph 41.

26 Q That is a quotation from what Ofcom, but I am trying to understand how you are explaining
27 either you, that is BT, or Deloitte took into account the fact that it may not be completely
28 accurate to use terminating charges as a proxy for trunk charges. In other words, what
29 sensitivity analysis do we see anywhere?

30 A We supplied this data because we felt there were – as another way of thinking about BT's
31 position relative to other operators to Ofcom, and we went to discuss this data with Ofcom,
32 and you ----

33 Q Sorry, please finish, I do not want to interrupt you.

1 A And you certainly can take sensitivities and play around with this data. In many other
2 considerations there have been many sensitivities and re-calculations carried out.

3 Q I am just trying to find any sensitivity analysis that you undertook, or Deloitte undertook,
4 and I cannot find any?

5 A No, I did not undertake sensitivities to this data.

6 Q Were you expecting Ofcom to do it?

7 A I thought they would consider international price benchmarking, yes.

8 Q Is it not the case, Mr. Budd, that if you are using the terminating segment cost as a proxy for
9 the trunk segment cost, it is highly likely that you are going to overstate the prices in these
10 other countries?

11 A If you are using the terminating charge?

12 Q Perhaps I will make it simple. You are saying that for four of the countries you could not
13 find a charge for trunk – do you follow that?

14 A Yes.

15 Q Therefore, you assume that the charge for terminating is the same – do you accept that?

16 A Yes.

17 Q We know that the charge in the UK for terminating is substantially less than for trunk. We
18 know that as a given?

19 A Yes.

20 Q If that principle applied in these other countries, namely Belgium, Austria, Spain and
21 Germany, then you would overstate the price, would you not?

22 A If that principle applied in the other countries, yes.

23 Q We do not know, do we?

24 A We don't know if they have the same termination trunk balance on cost recovery, no.

25 Q We have got no idea about that?

26 A No, we don't know.

27 Q Do you think that in those circumstances, given the significant shortcomings of this data, it
28 was wrong for Ofcom to say, "We can attach limited weight to this"?

29 A No, because I think it would be reasonably straightforward to carry out the kind of
30 amendment you have suggested.

31 Q Who is meant to do that?

32 A I consider Ofcom could do that.

33 Q You understand that the burden is upon BT to show that its prices are cost oriented – do you
34 understand that?

1 A Yes.

2 Q So why do you say it was for Ofcom to do this work, to make good the deficiencies in your
3 data?

4 A I expect Ofcom to critically consider the issues before it. As I mentioned, in the 2008 there
5 was other data which showed that 2 Mbit trunk prices in the UK were in line with those
6 charges in other countries, which Ofcom had itself considered on an occasion in 2008.

7 Q Let us just stick with the determination at the moment because that is what we are here
8 debating. What I put to you is that it is not wrong in principle for Ofcom to say, given the
9 data we have seen, that limited weight can be given to this. Do you accept that?

10 A Yes.

11 Q Thank you. Perhaps we can put away BT3, please. Could you please have the
12 determination open at p.918, please. Could you please look at table 7.3. I will be corrected
13 if I am wrong, but I do not believe that is a confidential table. Do you see that, Mr. Budd?

14 A Yes.

15 Q Perhaps you can just have a look at that table before I ask you any questions about it, rather
16 than going into it cold, but if you want me to start I can start.

17 A (After a pause) Thank you.

18 Q The weighted average cost of capital for BT is around about 12 per cent – is that correct?

19 A Yes.

20 Q As an average?

21 A Yes, all years, yes.

22 Q If you will please look in that table at 918, about three-quarters of the way down you will
23 see “Trunk, 2Mbit/s”, and then you will see various percentages, 76 per cent, 102 per cent,
24 etc, etc. Do you see that line?

25 A The All Trunk ROCE?

26 Q Just above that, I am looking at 2Mbit/s, please.

27 A Yes.

28 Q If you do not know the answer to this or you do not want to answer it yet without thinking
29 about it, please tell me, but as I understand the position of BT it is not disputed that the rate
30 of return of capital that BT was earning from 2Mbit trunk segments alone was between 76
31 per cent and 109.2 per cent in these years?

32 A These are Ofcom’s calculations after some adjustments to numbers.

33 Q I am sorry, 109 per cent is all years. So it is between 76 per cent and 142 per cent.

34 A Yes.

1 Q Do you dispute these calculations? The reason I ask you this question is because you are
2 the man who is put forward by BT as a person speaking to the figures.

3 A Yes.

4 Q Do you dispute that that was the rate of return, between 76 per cent and 142.1 per cent?

5 A No, I haven't disputed those numbers.

6 Q Can you turn to your statement, please, at para.10, where you address returns on PPCs, and
7 if you want to refresh your memory perhaps you could look at paras.10 to 13, first of all. I
8 do not want to refer to the particular percentages there because they are marked as
9 confidential, I believe.

10 A Thank you.

11 Q You recall those paragraphs?

12 A Yes.

13 Q Would it be fair to say that underlying each of these percentages here, without me
14 mentioning what the percentages are, is an approach which aggregates trunk and
15 terminating segments – these returns?

16 A That is correct for the return in para.11. It is a PPC return.

17 Q If you could look at table 1, para.13 over the page?

18 A Yes, that is the rate of rate of return earned by BT providing PPCs to CPs.

19 Q So that all depends on aggregation of the two – is that correct?

20 A It's the rate on the return on the product sold which is composed of a trunk and terminating
21 component.

22 Q Would it be fair to say, and I hope you still have table 7.3 open in the determination.

23 A I have it open, thank you.

24 Q Do you have that?

25 A Yes.

26 Q Can you look at the table and the bottom of the page, we see aggregated figures, and then
27 total PPC returns on capital. Would it be fair to say that the sole reason that we see a
28 radical reduction in the return of capital when one looks at the total PPC return on capital is
29 the inclusion of lower returns on terminating segments?

30 A Sorry, Ofcom show a total PPC ROCE of 12.2 per cent, and my first para.11 shows what
31 the rate of return would be were the DSAC prices to have applied over the period.

32 Q Perhaps I have not made my question clear, perhaps I could put it more crude terms, which
33 is what brings down the rate of return on capital in these charts? Is it not the lower rates on

terminating segments, because we can see that the rates on trunk segments, in particular on 2 Mbit, are very high? Is that not self-evident from table 7.3?

A The PPC ROCE at 12.2 is an average of the trunk and terminating numbers shown by Ofcom.

Q I was trying to make it simple for myself, rather than you, which is trying to understand what brings down the rate of return, and it seemed to me self-evident that what brings down the rate of return are the returns on terminating segments – is that self-evident from 7.3? If it is not, please tell me, because I have obviously misunderstood.

A What brings the TISBO up is the higher trunk. What brings the higher trunk down is a lower TISBO. It is an average number, as I understand Ofcom have calculated this table.

Q Perhaps I could ask you to put that table to one side for the moment, and please look at Mr. Myers' statement, where he presents a table on which you make some comments later. Perhaps you can look at, first of all. It is core bundle 2, p.504. I do not believe this is a confidential table. We saw a few moments ago, and I believe you accepted, that the rate of return that BT had achieved on 2 Mbit was very substantial. We saw it as between 76 per cent and 142 per cent – you remember that?

A Yes.

Q Is it not also the case that when one takes into account repayments on 2 Mbit trunk, which one sees at table 3, the rate of return remains very high?

A Effectively, that is the rate of return at the DSAC price ceilings.

Q Yes?

A Yes.

Q It remains very high, does it not?

A It's about 50 per cent.

Q Which is substantially more than the 12 per cent cost of capital, is it not?

A Yes, it's higher than the cost of capital for BT, yes.

Q Would you accept, Mr. Budd, that when Ofcom considered whether or not there was overcharging, they considered that issue on disaggregated basis – in other words, you just looked at 2 Mbit on its own. That was their approach, was it not?

A They do in a number of places discuss the rate of return of PPCs overall.

Q Is there not a distinction between two different matters – first of all, whether or not there has been an overcharge. What I am putting to you is that when they are deciding whether or not there has been an overcharge they consider the figures on disaggregated basis, and by

1 contrast when they are considering whether it is fair to require you to repay they do along
2 the road with you and consider aggregated figures?

3 A Yes.

4 Q Do you accept that is the approach?

5 A Having made the decision to disaggregate they look at disaggregated trunk rates of return,
6 yes, and then they do consider the impact of the repayment on BT's total returns on the PPC
7 product.

8 Q You know – keeping these two points separate for the moment – whether or not there has
9 been an overcharge disaggregated, whether or not to require repayment aggregated, bearing
10 in mind in those two distinctions, there is a disagreement, is there not, between yourself and
11 Mr. Myers as to the figure relevant to the second point. In other words, when considering
12 whether there should be a repayment of the overcharge, both you and Mr. Myers disagree as
13 to rate of return looking at PPCs as a whole. Is that not the case? I am not trying to trip you
14 up, I am just trying to identify for the Tribunal points that they are going to need to decide
15 and what you disagree upon. So stated again, we are looking at, should you be required to
16 repay, BT has its own figures of what its aggregated rates of return are?

17 A Yes.

18 Q Ofcom has its own figures?

19 A Yes. I am slightly finding this a bit hard to follow, but I thought the repayment was a
20 known and agreed amount.

21 Q No. I do not think it is the amount of the repayment. Perhaps I am not making myself
22 clear. Let me go back to the two issues. Let us not look at the amount of the repayment.
23 Forget that, please, completely. When looking at the effect of a repayment, in other words,
24 what net position does it leave BT in after there has been a repayment? Ofcom and Mr.
25 Myers took into account aggregated figures.

26 A Okay, yes.

27 Q Both you and Mr. Myers disagree on what the rate of return is. Just to remind you, if you
28 can please look in your own statement at paragraph 11, I will not read out the figure at the
29 end of paragraph 11 at p.309 of your first statement. Do you recall that figure?

30 A Of course, yes.

31 Q Do you recall that Mr. Myers has a different figure? Perhaps to help you I can show you his
32 figures. In other words, a direct, comparator figure for that.

1 A That paragraph is not about repayments. It says, “The impact of the price reductions to
2 DSAC would have been to reduce the rate of return ...” to the number given. That is a
3 calculation of what the return would have been at DSAC prices.

4 Q Yes, which is the position after the repayment.

5 A For external customers it is the position after repayment, yes.

6 Q What I am trying to get to the bottom of is that the Tribunal is going to have to rule as to
7 which is the correct approach. Perhaps I can put this in context. It is put as part of BT’s
8 case that the net result of this whole decision is that BT overall – that is aggregating trunk
9 and terminating – is going to be earning less than its cost of capital on PPCs. Do you
10 understand that?

11 A I think the way I would put it is: at the DSAC price ceiling, BT would have earned less than
12 its weighted average cost of capital.

13 Q I do not want to do anything more, please, than ask you to read paragraph 11 and just
14 confirm that in paragraph 11 the figure that is quoted there, the percentage which I will not
15 read, is the amount, the percentage, that you would have earned. You were making the
16 point that that percentage is less than your cost of capital. That is after repayment.

17 A After repayment? It is at the DSAC prices.

18 Q After repayment?

19 A They are post-repayment prices.

20 Q We are not disagreeing at all on that. By contrast, if you keep that open, if you look at Mr.
21 Myers’s statement, that is paragraph 122, p.523, you will see that Mr. Myers has quoted
22 your paragraph 11. Do you see that?

23 A Yes.

24 Q He has put your figure in there and you will see that at 123 – I do not know if this is a
25 confidential figure but it does not seem to be marked “confidential” – that in fact Ofcom’s
26 conclusion was that the impact of the price reduction to DSAC was to reduce BT’s return on
27 PPCs as a whole from 15.1 per cent to 14.2 per cent. Do you see that?

28 A Yes.

29 Q Above your cost of capital. As he says there, Ofcom considered that factor in deciding
30 whether or not to require repayment. Do you see that? There appear to be – please disagree
31 with me if I am not stating the position correctly – two reasons for the difference in your
32 figures. The first reason is – and this appears from paragraph 124A of Mr. Myers’s
33 statement – that you assume that the price reductions also apply to BT’s internal sales. Is
34 that correct?

1 A Yes.

2 Q The second is you assume that the prices in 2004/5 when there was not an order for
3 repayment would also be reduced. Is that correct?

4 A No, that's not correct. It's more that I simply use a different period to Mr. Myers. I use the
5 2004/5 to 08/09 period, and all years due.

6 Q Let us take these two points in turn. Let us deal with that one first. Mr. Myers's point is
7 very simple, which is that Ofcom is assessing the effect on BT's rate of return of an order
8 for repayment. You follow that?

9 A Yes.

10 Q His point is that it is illogical when assessing the effect on the rate of return when ordering a
11 repayment to assume that there was a repayment in a year when Ofcom had decided there
12 should be no repayment, namely 2004/5. That is his point, is it not?

13 A If you are considering a period, the original dispute was from 2004/5 and I would have
14 thought a year when there wasn't over-recovery, in the words used, could be considered as
15 being relevant. We have the same assets being used here. The same fibres are being used
16 year to year. I can see you can take a period of the full five years or a shorter period, but
17 there is a complication that one of the years only has half a year's repayment in it, so again
18 you can look at the full year effect or very precisely just stop at the three and a half years.

19 Q With respect, Mr. Budd, my point is actually very, very simple. In 2004/5 there was no
20 requirement, as a result of the determination, for any repayment. Do you accept that?

21 A That's right.

22 Q Therefore, when you are working out the rate of return that BT would have enjoyed, you do
23 not assume that there was an order for repayment for 2004/5. It makes no sense, does it?

24 A No, we didn't reduce the moneys in 2004/5. It's just whether we included that year or not
25 in the period we looked at. We looked at table 7.3 and there was an all years number given.
26 I was just trying to be consistent with the all years approach.

27 Q I will put my point to you once more and for the last time. There was no requirement for a
28 repayment in 2004/5. You accept that?

29 A Yes.

30 Q Therefore, it makes no sense to assume when you are working out your rate of return that
31 there was an order for repayment in that year. If you want to look at 124B of Mr. Myers's
32 statement it could not be clearer. Another difference is that the Budd statement includes
33 2004 and 2005 in the average. However, 2004/5 should not be included because Ofcom did

not find overcharging in 2004/5. There was no impact of repayment in this year. What, I ask you, Mr. Budd, is wrong with that as a matter of logic?

A 124B of Myers?

Q 124B, p.524. If you want some reminding, he here is trying to understand and explain why there is a difference between his figure of 15.1 per cent to 14.2 per cent and your figure, which I will not quote, which is at paragraph 122. The simple point he is making is it makes no sense to assume that there was a repayment in 2004/5 because there was not a repayment. There was no finding of overcharging in 2004/5. What I want to know from you, Mr. Budd, is what is wrong with that.

A I thought the difference was due to the second sentence. The rate of return was lower in that year and that's why there was a debate about the use of the year.

Q Let us imagine there are two separate points, please. There is a "furthermore" you will see in the second sentence. Let us put that point to one side completely. We can disagree about the other point. I am making to you a very simple point based on the second sentence of B which is: "However, 2004/5 should not be included because Ofcom did not find overcharging." As I understand it, you are not disagreeing with that.

A No.

Q Secondly, if we go to 124A, another reason for the difference between yourself and Mr. Myers in the figures you get to for the rate of return after taking into account repayments is that you assume that, internally within BT, there was a movement of money from BT's buying arm to its wholesale arm. Is that a fair summary of the dispute at 124A?

A No. I did that because I assumed we would have been set non-discriminatory prices between our internal and external customers from our wholesale business.

Q We know that when one looks at rates of return for BT one is looking at BT across the board, is one not?

A No. Those numbers we looked at in table 7.3 were for BT's network business.

Q The network business which is relevant to the question of what the average cost of capital is. That is right?

A The network business to which the controls applied and to which the WACC applies, yes.

Q Is not Mr. Myers's point a sound one at 124A, which is that BT has had this money? In other words, within BT in one hand or another there has been this money and it has not moved anywhere. It has just moved from one hand to the other. That is correct, is it not? I am not asking about non-discrimination for the moment. One hand of BT has passed

1 overcharged, if you will have it, another arm of BT and it has passed the money over.

2 Correct?

3 A Yes. One part of BT which is the network business we are talking about has priced above
4 DSAC. Yes.

5 Q Ofcom has overcharged its internal customer. You agree with that?

6 A Yes.

7 Q All Mr. Myers is saying is: “when I am looking at the effect of overcharging on BT as a
8 whole, when I am deciding whether or not to order a repayment, it is right as a matter of
9 principle to ignore that because the money has remained within BT”?

10 A But as a matter of principle you should always charge the same amounts internally and
11 externally. My calculations took the perspective as the DSAC being a ceiling and it being
12 adhered to all the time to see what the impact of that would have been on the rate of return.

13 Q I will ask you again to bear in mind the question that Ofcom was considering here and the
14 question Mr. Myers considered, which is what is the effect on BT’s rate of return of
15 requiring repayments, and would you agree with me that, so far as BT as a whole is
16 concerned there is no effect?

17 A You cannot look at the rate of return for BT as a whole, because you need to think of it in
18 terms of the business that is being regulated. It is just not comparing like with like, is it, to
19 have the repayments only going to a proportion of the network business.

20 Q Mr. Budd, I will leave that point, ultimately the Tribunal is going to have to decide on these
21 two issues of principle between yourself and Mr. Myers, but I should make it absolutely
22 clear what Ofcom’s case is, that even taking into account the repayments, BT still earned a
23 rate of return above its cost of capital. You understand that, do you not?

24 A Ofcom’s position, yes.

25 Q But you do not agree with that?

26 A I think that is the wrong approach to adopt in considering the DSAC issues we have been
27 discussing. If DSAC had been this *ex ante* rule that was known about and adhered to we
28 would have had to have priced internally and externally the same, so I would look at the full
29 impact of that methodology.

30 Q I will not mention the point again about the difference between deciding on whether or not
31 to order repayment, and deciding whether or not there was an overcharge. I want to return
32 to a different point, please, which is your complaint about the circuit analysis and again this
33 is in your first statement, at para. 28. Sir, I am reminded by Mr. Segan that this may be an
34 appropriate moment for a break for the shorthand writers. I am in the Tribunal’s hands.

1 THE CHAIRMAN: I think five minutes would be sensible. Mr. Budd, I should warn you, or
2 remind you – I am sure that you already have been, that whilst we break you are in purdah
3 and should speak to no one about this matter; you are still on oath.

4 (Short break)

5 Q Mr. Budd, before the adjournment I was going to take you to your statement on the circuit
6 charges, I had the wrong reference; I have found the right reference now which is your first
7 statement, please, at para.26 in CB1 it is p.315. Perhaps you could just refresh your
8 memory by reading what you say there?

9 A Yes.

10 Q Would it be fair to say, and this goes over the page, there is a confidential table, I am not
11 sure – it looks as though it may be confidential – over the page there is a table indicating the
12 results of your circuit analysis, I will not read out the figures because they are confidential?

13 A Table 4, yes

14 Q Would it be fair to say that your points at paras.28 and 29 again depend on aggregating the
15 trunk and terminating segments?

16 A This is looking again at PPCs, and the key difference was we did not aggregate markets any
17 more, we started to look only at PPCs which included trunk.

18 Q Again, I do not want to go to the precise figures, but even adopting your aggregating
19 approach, which you know that we do not accept, one can still see overcharging, you accept
20 that?

21 A I prefer to express in my own words that there were some PPCs for which the charge was
22 above the DSAC even when you do the aggregation and those would be the PPCs in the
23 bottom row of the table.

24 Q I think you have answered my question, which is that this is when you do the aggregation,
25 that is correct, is it not?

26 A When you look at a PPC, yes.

27 Q You understand that Ofcom did not ignore this circuit analysis, it decided that because it
28 was premised upon aggregation it could not give this any weight, do you understand that?

29 A It could not give it any weight because it aggregated across services which are bought
30 together and actually manufactured jointly as well. So the product actually sold to our
31 customers.

32 Q Thank you. Could I please ask you next about DSAC, there is a large part of your first
33 statement which concerns DSAC, and it begins at 44 of your first statement, p. 322. The
34 impression one gets from your statement, and this may be an unfair observation, from paras.

44 to 66 is that you are not shown when drafting this statement, BT's own description of DSAC and BT's primary accounting documents. Would that be fair?

A I have read many big BT documents in my time, I did go back to first principles as an economist, not as an accountant putting together an accounting document, as an economist to look into DSAC and SAC.

Q Perhaps I can ask you, please, to look at, and you may not have this up there yet, which is bundle ADB4, it is a bundle that was introduced this morning. This may not be a document that you have seen before – I took the Tribunal through it this morning. It begins at tab 6, please. Hopefully the first page is headed: "Primary Accounting Documents 2nd September 2005". Do you have that?

A Yes.

Q Are you familiar with this document?

A Yes, I have seen the document, I cannot say I would know what is on every single page, but I have definitely seen this document.

Q Would you agree with me that this document contains BT's own descriptions of the DSAC and DLRIC measures?

A These would be descriptions of the DSAC and DLRIC measures in the regulatory accounts.

Q This is the BT document, is it not?

A It is the accounting document that supports the regulatory financial statements.

Q Drafted by BT?

A Yes.

Q Thank you. If you would please turn to p.55, and if you would please read the end of p.55 from: "A way of ensuring ..." down to the bottom of the page?

A I am sorry, where does the paragraph start?

Q I am so sorry, it is the second paragraph from the bottom and I will read it, just to make it clear from the transcript. I am reading from para.5.33 of the Primary Accounting Documents, p.55, which is tab 6 of ADB4:

"A way of ensuring that fixed common costs are recovered in the revenues is to conduct combinatorial tests whereby the aggregate revenue of services straddling the fixed common costs are required to equal or exceed the LRIC of these services measured as a single increment."

And I continue:

"Combinatorial tests have not been specified in the case of the Core increment. Instead, the recovery of the Intra Core Fixed Common Costs has been prescribed

1 by Ofcom through the use of distributed LRICs ('DLRICs') in determining cost
2 floors. This restricts pricing flexibility by setting a price floor for components in
3 excess of the actual LRICs. Ofcom uses this restriction in order to avoid complex
4 combinatorial tests."

5 If I can stop there, and if you could then please go ahead to para 5.3.5, p.58, if I may read
6 that. Under the heading: "Distributed Stand Alone Cost (DSACs) of Network
7 Components":

8 "A similar approach is taken with Stand Alone Costs in order to derive ceilings for
9 individual components. The economic test for an unduly high price is that each
10 service should be priced below its Stand Alone cost. As with price floors this
11 principle also applies to combinations of services. Complex combinatorial tests
12 are avoided through the use of DSACs, which reduce pricing freedom by lowering
13 the maximum price that can be charged. This results in ceilings for individual
14 components that are below their actual SACs."

15 Then continuing:

16 "SACs of two network elements are calculated, Core and Other Wholesale
17 Network components, taken together. Where ceilings for individual components
18 are needed, these SACs are 'distributed' between the components comprising
19 these increments."

20 Now, that is a description of DSAC, is it not?

21 A Yes.

22 Q It is BT's description of DSAC?

23 A Yes.

24 Q BT is well aware that DSAC is intended to set the maximum price?

25 A The DSAC is the first order consideration for considering possible non-cost orientation.

26 Q It does not say first order here, it is much more crude than that, is it not – the bit I have just
27 read to you?

28 A Yes.

29 Q "Complex combinatorial tests are avoided through the use of DSACs, which reduce pricing
30 freedom by lowering the maximum price that can be charged."

31 A Yes, this is not intended to be a policy document in any way, it is the accountants
32 explaining how the numbers in the RFS are calculated.

1 Q Would you agree with me then that when one sees the figures in the RFS, and we can look
2 at them if you want to, one obtains the significance of those figures from this description by
3 the accountants?

4 A The RFS should be read in conjunction with the PAD, yes.

5 Q Would you agree with me then that BT was perfectly well aware that Ofcom had prescribed
6 these distributed LRIC floors and these distributed DSAC ceilings?

7 A Those ceilings came from 1997 guidelines as we have seen earlier today.

8 Q But there is no doubt, and I will ask my question again, that BT was well aware of that –
9 correct?

10 A The existence of distributed SACs and distributed LRICs, yes.

11 Q As setting ceilings and floors, do you agree with that?

12 A They are indicative ceilings and floors. When you are talking about a ceiling, you need to
13 think about a ceiling in what regard.

14 Q Would you also agree with me that it is absolutely clear from this document that these
15 DSAC and DLRIC measures apply to PPCs?

16 A Because they are in a core service.

17 Q I think we are agreed on that?

18 A Yes.

19 Q Would you agree with me that certainly going back to at least 1997, and within the telecoms
20 industry, DLRIC and DSAC have an established history?

21 A They have a history since, as you say, 1997, and a discussion before then, before the
22 Guidelines came out.

23 Q So they are established within the telecommunications industry as measures?

24 A Established as cost concepts unique to us, and used particularly for voice services.

25 Q Would you also agree with me that the purpose of DLRIC and DSAC is to avoid complex
26 combinatorial tests?

27 A Well, they are short cuts. They are short cuts and imperfect short cuts derived from the
28 contestable markets theory that does require combinatorial tests, simplifications of the
29 theory, Ofcom say.

30 Q Are they a proxy for combinatorial tests?

31 A This has been an issue of debate. Ofcom don't seem sure.

32 Q What is your answer?

33 A I don't think they should be a proxy for combinatorial tests.

34 Q Happily that is a matter on which you and Mr. Myers are agreed.

1 A Yes.

2 Q One of the fundamental problems with doing combinatorial tests in this area, and one of the
3 things that DSAC seeks to avoid, one of the fundamental problems which I think you agree
4 with in your witness statement, is that it is very hard to know, when you do a combinatorial
5 test involving many services and it has failed, which particular service has caused the
6 failure. You agree with that, I think?

7 A Yes, a particularly wide set of services won't tell you much about an individual element
8 within that service.

9 Q Would you also agree with me that it is important, if you are going to do combinatorial
10 tests, and that is without prejudice to this fundamental problem which you have just
11 articulated for me, then the logic is that you include the services that share the common
12 costs?

13 A Technically, you should do every combinatorial, and this is the billions problem. Then you
14 do need to consider which combinatorial set of services you test. The consideration you've
15 given, which was put to in the final determination, is a consideration that may be relevant,
16 but of course the more services you include the further away you are from getting at the
17 service of interest.

18 Q In a sense, that is exactly one of Mr. Myers' points, is it not, in his statement? I think you
19 are both agreed on that, that the more combinatorials you do the less useful they are in
20 identifying why or which service has caused the failure?

21 A Yes, that is a problem with very broad combinatorials.

22 Q Would you accept that Ofcom made it clear to BT that if there were to be any useful
23 combinatorials there would have to be a huge number of them?

24 A Ofcom did say there was a huge number that could – and the theory, the abstract theory,
25 does mean you need to do a huge number of combinatorials.

26 Q Could I ask you, please, to go to your second statement, para.46, at p.359 of the core
27 bundle. Could you read that to yourself, please? (After a pause) Have you read that?

28 A Yes.

29 Q There you appear to be suggesting that the problem in respect of combinatorials, or, in fact,
30 the number of services across which the combinatorials would have to be conducted, that
31 point had been made for the first time by Ofcom in the course of these proceedings?

32 A No, I think that the point that Ofcom made for the first time is the idea that we should have
33 drawn a broader combinatorial than the core combinatorial which we did. That, I think, was
34 the access network combinatorial.

1 Q Would you agree with me that Ofcom had made it clear that if any combinatorial process
2 was to be undertaken, it had to include many more services than those services currently
3 included in your combinatorials?

4 A And that's why we did the core combinatorial which the DSAC comes from, which spans
5 the whole of the core network, the inland conveyance network.

6 Q And it does not include the many other services of BT which share common costs with
7 trunk – do you accept that?

8 A If you do that you are starting to test for the whole of BT's business.

9 Q I do not want to know about the consequence, I just want to see if you agree with me. You
10 did not do that test, did you?

11 A We did no broader test than the core combinatorial test.

12 Q Would you agree with me that Ofcom suggested to you prior to the determination that any
13 test had to be wider than those which you had hitherto done?

14 A I'm sorry, could you repeat that question?

15 Q Do you accept that Ofcom suggested to you prior to the determination that the
16 combinatorial tests that you needed to do would need to be wider than those which you had
17 hitherto done?

18 A Well, we met Ofcom and we wrote to Ofcom and asked them which tests they would like us
19 to do in July 2009.

20 Q And they told you, did they not – this is in a confidential letter but I will explain it in broad
21 terms – did they not say to you in clear terms that any useful test would have to include
22 every combination of services that shared common costs with 2 Mbit/s? That would be a
23 vast exercise?

24 A It would be a vast exercise, and it would get you back to rate of return regulation, a point
25 Ofcom also made to us.

26 Q But they made that point to you clearly before the final determination – is that not the case?

27 A They did say that the theory required a vast number of tests to be done.

28 Q Prior to the determination?

29 A Yes, but we explained why we considered that the combinatorials we had done were the
30 appropriate relevant ones.

31 MR. SAINI: Thank you very much, Mr. Budd.

32 THE CHAIRMAN: Miss Rose?

33 MISS ROSE: I have no questions for this witness.

1 MR. READ: I have a few questions, I am afraid, in re-examination of Mr. Budd. I do not know
2 how late the Tribunal wants to sit, whether they are happy to go past 4.30 to finish this
3 witness or it may be that the Tribunal today would like a 4.30 finish. We are actually quite
4 well up on our timetable, but I leave it to the Tribunal. I do not want to take them past 4.30.

5 THE CHAIRMAN: It is reassuring to know about the timetable, but I think it would be helpful if
6 we could finish Mr. Budd this evening.

7 Re-examined by Mr. READ

8 Q You were asked a series of questions about whether Ofcom had put any weight upon the
9 question of international benchmarking. Can I take you to the draft determination, which is
10 in one of BT's bundles, so it is called BT 1, not core bundle 1. Can I ask you to look at tab
11 4, the draft determination, and can I ask you to look at p.27 Do you have the page?

12 A Yes, Mr. Read.

13 Q If you look at para.3.36, there is Ofcom's approach to the Deloitte material put down there.
14 Do you see the paragraph. Would you like to read the paragraph to yourself? (After a
15 pause) Are you there?

16 A Yes.

17 Q Did you think that that reflected a fair analysis of the Deloitte report?

18 A Yes, para.36 is saying like for like comparisons are not always straightforward and that
19 country circumstances have often differ, and that is a relevant consideration in interpreting
20 results.

21 Q So you felt that that was a fair summary of what Deloitte were saying at that particular
22 point in their report. Is that what you are saying?

23 A Yes.

24 Q Can I ask you about para.10 of your witness statement, which, if you remember, is in the
25 second core bundle, tab 10, p.308. I am looking at the area that you were being asked
26 about, which is para.11, but that section starts at para.10. Do you have the relevant bit?

27 A Yes.

28 Q The questions were being put to you on the basis that these calculations were done by you
29 in order to consider the repayment position.

30 A Yes.

31 Q Were you only doing these calculations for the basis of considering whether there should be
32 a repayment or for any other reason? Perhaps that is a very open ended question. I am
33 interested in why you have come up with the figure in paragraph 11. Was it simply to deal

1 with the proposition that was being put to you about repayments, whether they were fair or
2 not, or was there any other purpose for your calculating that figure?

3 A No. I wanted to show the result of applying the DSAC test as an *ex ante* price ceiling and
4 what it would have meant for BT's rate of return had such regulation been in place and
5 adhered to over the period.

6 Q You were asked several questions about whether it was right to be using 2004 to 2009 and I
7 think you referred at several places to table 7.3 in the final determination. Can I ask you
8 now to take core bundle 2?

9 A Page 918?

10 Q Yes. I want to ask you a couple of questions about this but, firstly, that table is obviously
11 considering the period from 2004 to 2008 and 2009. Did you see any reason at all to depart
12 from that period?

13 A No.

14 Q There has been reference to the weighted average cost of capital. If you do not know the
15 answer to this, by all means say you do not know the answer to this. Upon what basis is the
16 weighted average cost of capital calculated?

17 A It's effectively the assessed costs for BT of investing in fixed infrastructure and its
18 networks.

19 Q You are saying its networks. How wide is the calculation done for the weighted cost of
20 capital?

21 A It used to be done for the whole of BT and it has been tweaked slightly in about 2005/6 to
22 look at the Openreach business and the rest of BT. It's been de-averaged. It used to be a
23 single number for the whole of BT.

24 Q We see on p.919 the total PPC ROCE. That ROCE is obviously self-evident I think from
25 the table. I do not think I need to be careful about what I ask you on this. What is that
26 ROCE calculation based on? On what element of the BT network?

27 A That would be based on the regulated network business that provides Partial Private
28 Circuits.

29 Q The BT weighted average cost of capital is therefore based on the same level of service, or
30 is it a wider level?

31 A You can't specifically identify individual cost of capital for different parts of BT so you
32 make one calculation as a cost of raising funds for BT as a PLC.

1 Q Just returning to the question of international benchmarks, you were asked questions about
2 why it was for Ofcom to consider international benchmarking. Does BT have the same
3 access to international benchmarking data as Ofcom?

4 A I don't think BT has better access at all than Ofcom. Obviously, one would have to do
5 some research and go to the markets in question and perhaps even the regulators in
6 question.

7 Q Could BT go to the regulators in question?

8 A You can ask anyone for information. Whether they have the time to answer you, BT could.
9 Ofcom could go to the regulators, but if something has been non-cost orientated the
10 regulators might say we haven't got time to help you, so you do have to do some research
11 which is what we asked Deloitte to do.

12 Q Would there be any difference at all between the level of cooperation that might be given by
13 a European regulator to BT or to Ofcom.

14 MR. SAINI: Mr. Read has not derived that out of any questions asked in cross-examination.

15 MR. READ: With respect, it comes directly out of the question that my learned friend was
16 putting to him as to saying why exactly the onus should be on Ofcom to make any
17 investigation about the international benchmarking figures. That was the question that was
18 actually being put to him.

19 THE CHAIRMAN: Carry on for a little but keep it short.

20 MR. READ: Mr. Budd, the question that I am trying to put to you is this: in terms of accessibility
21 and in terms of the opportunity to get data out of the regulators, do you believe BT and
22 Ofcom are on the same playing field?

23 A No, they wouldn't be. Ofcom are members of the European Regulators Group and
24 obviously the regulators do confer and work together, sometimes in informal groups.

25 Q You were asked a series of questions about contestable market theory and the focus. It was
26 put to you that one of the problems is that it is very hard to know which service caused the
27 failure in the SAC combinatorial tests. Could I ask you to find bundle DF3? If you go to
28 tab 4 you should have there the national Leased Lines Effective Competition Review and
29 Policy Options, August 2000. Do you have that?

30 A Yes.

31 Q It helpfully has rubber stamped pagination numbers at the right hand side of the page. Can
32 you go to p.54? Can I just ask you to look at B1, B2 and B3? Have you been able to read
33 those paragraphs?

34 A Yes.

1 Q Would you say that that broadly is an accurate summary of combinatorial testing?

2 A Yes.

3 Q What is the focus of the purpose in conducting the initial SAC test?

4 A The SAC test, the focus, is to see whether the combination of revenues is so high that it

5 would encourage an entrant to enter with the same set of services, so it is a kind of entry

6 idea. If revenues were above the stand alone cost, you would expect entry to occur.

7 Q Would it be fair to categorise this? To what extent, having said that, do you agree with the

8 point about whether it will tell you anything about an individual element?

9 A The broader the SAC test, the less it will tell you about an individual element. If you are

10 really interested in an individual element, you can do a stand alone cost test for that

11 individual element, which is one of the ones we did of course.

12 Q Thank you. You will be glad to know that I am finished.

13 (The witness withdrew)

14 THE CHAIRMAN: Mr. Saini, it was the calculations that Mr. Myers did at paragraph 124 of his

15 statement which you will know better than I had two sub-paragraphs (a) and (b). I wonder

16 if it would be possible to ask him to do the calculation that he does in (b) where he uplifts

17 the first figure which is confidential to 14.2 per cent separately as if (a) had not been

18 written. In other words, so we have two independent calculations of the data.

19 MR. SAINI: Certainly.

20 THE CHAIRMAN: Until ten o'clock tomorrow.

21 (Adjourned until 10 a.m. on Friday 22 October 2010)

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