IN THE COMPETITION APPEAL TRIBUNAL

Case No. 1160-65/1/1/10

Victoria House,
Bloomsbury Place,
London WC1A 2EB

14 October 2011

Before:

VIVIEN ROSE
(Chairman)
DR ADAM SCOTT OBE TD
DAVID SUMMERS OBE

Sitting as a Tribunal in England and Wales

BETWEEN:

(1) IMPERIAL TOBACCO GROUP PLC
(2) IMPERIAL TOBACCO LIMITED

Appellants

– v –

OFFICE OF FAIR TRADING

Respondent

CO-OPERATIVE GROUP LIMITED

Appellant

– v –

OFFICE OF FAIR TRADING

Respondent

WM MORRISON SUPERMARKET PLC

Appellant

– v –

OFFICE OF FAIR TRADING

Respondent

(1) SAFEWAY STORES LIMITED
(2) SAFEWAY LIMITED

Appellants

– v –

OFFICE OF FAIR TRADING

Respondent

(1) ASDA STORES LIMITED
(2) ASDA GROUP LIMITED
(3) WAL-MART STORES (UK) LIMITED
(4) BROADSTREET GREAT WILSON EUROPE LIMITED

Appellants

– v –

OFFICE OF FAIR TRADING

Respondent

(1) SHELL UK LIMITED
(2) SHELL UK OIL PRODUCTS LIMITED
(3) SHELL HOLDINGS (UK) LIMITED

Appellants

– v –

OFFICE OF FAIR TRADING

Respondent

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HEARING (DAY 14)

Note: Excisions in this transcript marked "[…][C]" relate to passages excluded.

APPEARANCES

Mr Mark Howard QC, Mr Mark Brealey QC and Mr Tony Singla (instructed by Ashurst LLP) appeared on behalf of the Appellants Imperial Tobacco Group Plc and Imperial Tobacco Ltd.

Mr Rhodri Thompson QC and Mr Christopher Brown (instructed by Burges Salmon LLP) appeared on behalf of the Appellant Co-operative Group Ltd.

Mr Pushpinder Saini QC and Mr Tristan Jones (instructed by Hogan Lovells International LLP) appeared on behalf of the Appellants WM Morrison Supermarkets Plc and Safeway Stores Ltd and Safeway Ltd.

Mr James Flynn QC and Mr Robert O'Donoghue (instructed by Norton Rose LLP) appeared on behalf of the Appellants Asda Stores Ltd, Asda Group Ltd, Wal-Mart Stores (UK) Ltd and Broadstreet Great Wilson Europe Ltd.

Ms Dinah Rose QC and Mr Brian Kennelly (instructed by Baker & McKenzie LLP) appeared on behalf of the Appellants Shell U.K. Ltd, Shell U.K. Oil Products Ltd and Shell Holdings (U.K.) Ltd.

Mr Paul Lasok QC, Ms Elisa Holmes, Mr Rob Williams, Ms Anneliese Blackwood and Ms Ligia Osepciu (instructed by the General Counsel, Office of Fair Trading) appeared on behalf of the Respondent.

Friday, 14 October 2011

(10.00 am)

Further opening submissions by MR HOWARD (continued)

THE CHAIRMAN: Yes, good morning.

MR HOWARD: Good morning. What I am going to do this morning is I am going to first look at this question as to whether the differentials in the Morrisons agreements or arrangements were maxima or fixed, then I am going to look at the different scenarios which need to be considered, namely Imperial price increases, Gallaher price increases and Imperial decreases and Gallaher decreases.

In doing so I also will come back, when I am dealing with the Gallaher price decreases, to a point raised by the Chairman yesterday evening, just to explain why I think what you described as the issue we say is not actually really the issue. It's better if I come back to it once we have looked at the documents.

So maxima against fixed. We have partly covered this already. In the two agreements, agreement number 1 at tab 4 and agreement number 2 at tab 85, it is clear beyond argument that agreement number 2 is expressed in what we are calling maxima. The language is slightly awkward. By "maxima" we mean at least this difference. Agreement number 1, that is also true, except in those

cases where it says "level with on", that's at tab 4, page 5.

Now, the evidence on both sides of the parties to the arrangements is that this was always understood that that meant at least and no worse than level. You will hear the evidence of Mr Eastwood and Mr Matthews.

Now, common sense also tells you that is the case. When I say common sense, I mean common sense in its normal parlance, but I also mean common commercial sense.

What is the OFT's position on this? They look at certain correspondence, which we are going to look at in a moment. In relation to the second agreement they say: well, although that says on its face what Imperial and Morrisons say, they say that because a prior draft -- which you have amongst other places at tab 72 -- was expressed in different terms, then that must be what the parties intended.

Well, obviously the short answer to that, firstly, is the parties intended what they put into the agreement which is actually ultimately signed, but even leaving that on one side, of course we say in any event, even if the agreement had been expressed in those terms, the parties still actually always understand that these are maxima, and if you can do better, then so much the

better, so it doesn't actually make any difference.

Now, if we turn to the some of the correspondence that has been cited both in writing and orally, if you would turn first to tab 16, {D17/16}, this is a letter that the OFT cited both in its skeleton at paragraph 253 and Mr Lasok cited it orally.

Now, one of the things that was interesting about Mr Lasok's oral submissions -- of course this is a common thing that counsel do, is to set up a straw man to knock down. So Mr Lasok, when he referred to this letter, said that this letter, because it refers to price increases, shows that -- this is his words -- he says:

"ITL is not an inveterate price cutter. ITL does not have that as its policy".

So he seems to be saying "Well, if I can show you something in the documents where ITL is putting up prices, that somehow must show that the OFT's case is right".

Now, the fact that a manufacturer puts up prices is something that happens day in, day out, there is nothing anticompetitive about manufacturers putting up their prices. What is in fact happening in this letter, if we look at it a bit more closely, and it's actually a very clear letter, the second paragraph:

"You are aware that the broad marketplace has moved [it's about Richmond] from 3.29/3.30 to 3.34/3.35 on Dorchester and Dorchester Superkings. You may remember from my presentation on the Richmond repositioning, launch of Richmond, that our strategy is parity with Dorchester. In light of this, we are moving Richmond and Richmond Superkings up to 3.34/3.35. In order to maintain your cash margin position, the bonus levels at 3.34/3.35 should be as follows."

Just stopping there for a moment, what has happened is that Imperial has previously reacted to Dorchester's price, and has paid an increased bonus to get the price down, and so at 3.29 they were paying an additional bonus, if you look at the figures -- I am going to say what they are, because it's quite frankly difficult to make any sense of this if you don't -- the additional bonus was £4.31. You can see that.

At a new shelf price of 3.34, the additional bonus is 2.18. At these levels, the margin is in cash terms exactly the same. It of course changes in percentage terms, because that's just a function of mathematics, but what you can see is happening is Imperial pays £4.31 originally per whatever it is -- I suppose that's per thousand or something, I think. Yes, per thousand -- in order to get the price down. Now they are saying "Well, I no longer want to have the price down at that level, so I am prepared to pay you £2.18 and that, Morrisons, will give you the same margin of 0.1672p", slightly different in percentage terms.

No-one is saying to Morrisons -- and Morrisons never understand this -- that you can't keep the price down if you want, but of course if Morrisons keep the price down, for instance at £3.29, Imperial would be delighted, but then Morrisons per thousand cigarettes would be, you can see on these figures fairly clearly they would be making a loss, because per thousand cigarettes they will be subsidising the price by over £2, the difference between £4.31 and £2.18.

So this letter, which is said to be --

THE CHAIRMAN: That margin figure of 0.1672, is that ...

MR HOWARD: That's Morrisons margin.

THE CHAIRMAN: Yes, but is that per pack, or per thousand, or ...

DR SCOTT: I think it's on the shelf price, because if you look, it's 16p and the shelf price is about 3 quid, and it's about 5 per cent so it's --

MR HOWARD: It's definitely the shelf price, I think the Chairman's question was whether it was per single pack or per ten packs. I think it's per single pack.

DR SCOTT: And as we understand it, provided they were

competitive with their chosen rival, they were concerned about the margin, so that they would need to take the price up to sustain the margin.

MR HOWARD: Of course, Morrisons have a concern -- everybody has different concerns. One of the things that's very dangerous is to think that there is only one concern. Morrison's concern is to be competitive with Tesco, I think, here. But whoever it is they are benchmarking, Morrisons want to be the cheapest, essentially. They also want to make their margin. So this -- and the calculation that's being made here is Imperial understand what the margin is that they previously had. They have paid them a bonus to get the price down, and to allow them to maintain their margin, and that's because it's part of Imperial's strategy there to reduce the price. Morrisons might independently consider that they need to take a cut in this margin, but that doesn't -- I don't know whether that arose in this instance or not, sometimes it did. But in this instance, all this -- why are we looking at this document? It's because this document is relied on by the OFT as part of showing that the differentials are required to be fixed. It isn't actually showing that at all, because it's about something different.

It is in the context of Imperial's strategy that

they want Richmond to be priced, here it says that their strategy is parity, and that is at least parity, but it's not saying it -- this is the important point, it's not saying to Morrisons that "we have a requirement that you must, as it were, independently do this". What it's saying is -- it's actually a fairly simple example. "We see that Dorchester has moved up, we previously had paid you a bonus, so that we could match them, we don't need to do that any more, and it's costing us" -- you have to remember this costs Imperial a lot of money. You can see that, I don't know, I can't tell you at the moment the precise figure, but if they are paying £4.31 per thousand cigarettes, and this is a big brand, if they don't any longer need to do that from their commercial judgment because moving the price up to match Dorchester's meets their strategy in the sense that they believe -- that's the thing, their commercial judgment was right about this -- that Richmond at the same price is a better seller. And they have been proved right. Their judgment was vindicated.

DR SCOTT: So just to correct what you said just now, you said their strategy was to reduce the price. This strategy is to take the price up, as is explained in the last sentence of the second paragraph.

MR HOWARD: I don't think I -- then I must not have made

myself clear. Mr Lasok, I was commenting on what he said, said this shows that Imperial are not inveterate price cutters. I'm saying that's a straw man to knock down. It's not a necessary part of Imperial's case, that what they are always trying to do is to cut price, and one only has to apply a ha'peth of common sense to realise that if what Imperial does is always cut price, Imperial will go out of business pretty quickly. Of course, Imperial is trying to make money for its shareholders, nobody disputes that.

THE CHAIRMAN: Yes, what the OFT point to in this letter, and we will obviously have to hear what Mr Matthews says, is that -- two things, is my understanding. First, that when they say, "In the light of this we are moving Richmond up to 3.34, 3.35", those figures are the shelf price, they are not the wholesale price.

MR HOWARD: I agree.

THE CHAIRMAN: And secondly at the bottom sentence it says:

"Please let me know when you can move your shelf prices."

Rather than, "Of course we would be delighted if you didn't move your shelf prices, but we understand if you decide that you have to".

So I understand what you say this letter means, and that may be something different from what it says, and then -- or you may not accept that that's something different from what it says, and what we have to decide is whether it means what it says, if that's what the OFT say, or whether it means what you say they would have understood.

MR HOWARD: No, I think this is a debate that doesn't lead anywhere, that's really my point. For instance, if you say: is there any dispute that this is talking about shelf prices? No, of course it's talking about shelf prices. The point that the OFT seeks to draw from this letter is that where the agreement says, at this stage, "level with on", that means that it's fixed and it cannot be less. Now, all I am saying is you can't -- this agreement is not addressing, as it were, a requirement to say it must be at this and no more.

I'll come to that last paragraph in a moment. What you can see before you get there, all it's saying is "we are no longer going to pay you the same level of bonus because we now no longer need to. This is the consequence."

The last paragraph is actually:

"Please let me know when you move your shelf prices ... (... listing, multipack reductions may be a good time?) [your shelf prices] so Stephen Carroll and I can issue a new schedule of costs, et cetera."

What that is saying is that is to calculate the bonus because -- and again it goes back to this debate and the tension with the retailers that the retailers, when they haven't moved -- if my learned friends here, Morrisons, they may say, "Well, we see what you have said in this letter, but the thing is, we actually have all these cigarettes in our stores at this price, the original price, and therefore we expect that bonus arrangement to continue, we are not changing it". So what he is talking about in the last letter, is "tell me when you are going to do this so that I can then give you a new schedule which will reflect this". It doesn't mean that Morrisons is precluded from saying "Actually we are happy with the bonus at £2.18 per thousand, but --" Imperial is not saying "You can't price at £3.29. The reality is they recognise that it is unlikely, unless Morrisons have some special reason why they are going to promote Richmond or going to, or there is some competitive position with Tesco or somebody else that requires them to do that. The reality is they are likely to put the price at £3.34, because that's the price that will give them this margin.

DR SCOTT: You are talking about the cigarettes already having been purchased, but as we understand it, the bonuses envisaged to pay in retrospect.

MR HOWARD: These ones are paid off-invoice, in Morrisons, all of this is paid off-invoice.

DR SCOTT: All of this is paid off-invoice?

MR HOWARD: Yes.

DR SCOTT: So what they need to know implicit in this letter, then, is when are you going to change the prices so that we know when to change what we invoice.

MR HOWARD: Yes.

DR SCOTT: And their expectation from this letter is that they will change the prices to 3.34, 3.35.

MR HOWARD: Yes.

DR SCOTT: Now, what's not envisaged in this letter is some change other than that, so that it doesn't say, "In order to maintain your cash margin, bonus levels of 3.34, 3.35 should be as follows, but let us know if you change the prices to something else". It's expecting them to move to 3.34, 3.35.

MR HOWARD: It is expecting that they are going to move to that, but it's their decision ultimately whether they do. If they want to get -- if they are happy with less margin, then there is absolutely nothing to stop them saying "Actually, we are going to price below". It's all about, you have to remember, calculating the bonus. This is a price reduction. Even at the enhanced price it's still a price reduction --

DR SCOTT: From the RRP?

MR HOWARD: Yes. It's more than from the RRP -- well, if you want, just taking it from the RRP. And it's paying them to have a low price. The difference is it's not as low a price as it originally was. So in other words, all it's saying is "I originally paid you this amount to get the price down to £3.29, I now will pay you this amount to get it down to 3.34. It's not saying you can't price below 3.34, it's just that's the amount I am paying you, that's my target, 3.34, but I am not in any way inhibiting you if you want to go any lower, it is just I am not going to pay for it".

You have to see why people are writing these letters, it's to calculate how much money is to be paid. So when one says: oh, well, why didn't Mr Matthews write saying "And by the way if you want, you can carry on pricing at 3.29, but you will suffer a loss of £2". In a commercial setting there is absolutely no reason for him to say that. What he is actually interested in defining is how much he is prepared to pay, and that's what you extract from the letter. What you can't extract from the letter is that there is a requirement to keep in a fixed relationship Dorchester and Richmond.

In fact, it shows quite the opposite, because the fact that Dorchester was moving up, Morrisons were in fact perfectly entitled, if you hadn't written to them, to say, "We want to keep earning the bonus and we are going to keep Richmond at £3.29". They were perfectly entitled to do that, and still expect the bonus. "What it's making clear is we no longer have a need, because it's costing us a fortune and because we are trying to keep a competitive position, our competitive position is satisfied at 3.34."

DR SCOTT: We can put this to Mr Matthews, but it would have been more straightforward to say, "We are intending to reduce the additional bonus, we would like to agree a date for doing it, and this is the terms". Instead, he puts it in rather different terms, which is "expecting a move to 3.34, 3.35".

MR HOWARD: And to which the answer is: so what, frankly? All that he is saying is -- that's the point -- is "I expect you are going to move the price up because that's your margin, and that's the bonus I am paying". It's just recognising what Morrisons are trying to achieve. It's not, we would say, dictating to Morrisons what they must do, it's simply showing -- it's coming from the other end -- what we are prepared to do and what the consequence is.

THE CHAIRMAN: Let's save any further debate on this, I think, until what we have heard what Mr Matthews says.

MR HOWARD: Yes.

The point is that the context of this type of letter is that the reference to specific price points makes perfect commercial sense because it's in the context of what the level of bonus is going to be. What one has to get clear is what it's not. You have to remember, why are we actually having this debate about fixed and maxima? I think it's quite important to come back to: where does it fit in? It fits into the case in two respects, and when you look at this correspondence it is entirely contrary to what the OFT wants to say.

The argument about fixed is that where Imperial puts up its price, then there is an obligation on the retailer to put up the price of Gallaher in order to maintain that fixed relationship. Sorry, I've got it wrong, it's Gallaher putting up the price, and the reason they want to say it's fixed is because if it's maxima, if Gallaher put up their price, that has no -- there would be no obligation, on their case, for the retailer to act. Equally, when Imperial puts the price down, they want to say there is an obligation to put Gallaher's price down.

So that is why you are looking at this. It's in order to support those arguments, the fixed point, that it feeds through to that element.

DR SCOTT: If you read this paragraph, it starts with:

"You are probably aware that the broad marketplace has moved from 3.28, 3.29 to 3.34, 3.35 on Dorchester Kingsize and Dorchester Superkings."

In other words, Gallaher are going up.

"Our strategy is parity with Dorchester. In the light of this we are moving Richmond and Richmond Superkings up".

MR HOWARD: Yes.

DR SCOTT: That seems to be an expectation on the part of ITL that to keep their strategy at parity with Dorchester, they want the prices to go up, and therefore to pay less in bonus.

MR HOWARD: You are putting it round a particular way, to say that whereas the -- it's actually ignoring the commercial position of what's going on, that they want -- their competitive position is parity or better. But they, at this stage, have been paying a ton of money to get the price down to meet where Dorchester was. They no longer need to pay so much money, and therefore that's what is happening, they are altering the level of the bonus to seek to match Dorchester at a different level.

DR SCOTT: But what they appear to believe is that in order to get that bonus down, the reality of the situation is

that the retailer wants to retain the margin of 0.1672p, and that therefore the price needs to be at parity, reflecting their strategy.

MR HOWARD: Yes, exactly. That's exactly what I have been saying. I am not sure ...

THE CHAIRMAN: Let's try and make a bit more progress on the correspondence.

MR HOWARD: You have to remember that, just to conclude, there is a confusion, I think, in the discussion we are having between what Imperial -- what is it that Imperial is expecting to happen, and what is it paying for. The OFT's case is that where Dorchester's price moved up, there was an expectation, indeed a requirement, that Imperial's price moved up. They say that's (a) because there was a fixed relationship from the agreement and (b) because the agreement imposed the requirement.

Now, if there was -- if one just thinks about it for a moment, if that were right, that there was a requirement, then the price would be moving anyway, you wouldn't need any of this correspondence about things going up or down, it would all just be something that the retailer would be doing.

The next document, 17 and the one after that, 18, they are further examples. What you see here is he says:

"The following changes have been made. Please find attached a new schedule of costs, bonuses and margins. The following changes have been made."

So if we take the first one:

"Embassy and Regal: multipack bonuses returned to ongoing levels from Monday, 15 January. This is in response to our closest competitor's decision to end the 1999 [whatever it is] price points on B&H Silk Cut from this date."

Then you have a schedule. Again, all that they are doing is responding to a situation where they no longer need to be providing such large bonuses.

An example of a situation that we have in the papers is at tab 75(a) where Morrisons seek to reduce the price and to extract a bonus, with you where Imperial don't feel it's incumbent on them. So at tab 75(a), you should have an email from Paul Giles to Paul Matthews, where he says:

"The following prices have been keyed effective 6 January. Please let me have a new cost schedule back with improved costs maintaining our profit at these levels."

So you can see prices for Golden Virginia.

"This will take us to a level equal to where the market seems to be. As you can guess, Old Holborn is

going to the same prices on the same date. There are some changes on cigarettes but not on any of yours."

At the bottom, in the bolder manuscript, it says:

"Why I will not pay. It's Morrisons' decision to move, not mine. I want to keep profit in roll-your-own, but especially in Golden Virginia. The only reason we are spending money on Drum is because Amber Leaf seems determined to take value out of the market. I am/we are not supporting Golden Virginia elsewhere. If there is a market rate, your competitors are funding it. I don't just allow Morrison to dictate my investment. I have been generous."

So there you have an example of where Morrisons are trying to extract money because they want to reduce the price, and the response is: well, we paid you enough already, we don't think we want to pay you any more. And they reduced the price because that suited their commercial position in the light of their benchmark.

Now, can we turn to the position of an Imperial price increase. As you remember, Imperial price increase is what has been described as the central plank in the OFT's case. For this purpose, the fixed/maxima debate doesn't matter, because they say in either case compliance would require Morrisons to move the Gallaher price up where Imperial is moving its price up.

Now, it's clear, we say, from the agreements and the practice that Imperial did not require Morrisons and Morrisons did not understand there any requirement to increase the price of a Gallaher brand following an increase in the wholesale price of ITL.

Now, let's just have -- you will hear the witnesses -- a look at some of the correspondence that is in the file. If you would, please turn to tab 19. This is a letter where it says:

"You may remember that in my recent note [it's after the MPI] about Richmond I said that Richmond brands were not going up in the MPI. This is not strictly true as the cost prices are going up, however I do want to hold the shelf prices of all Richmond packings in their current levels."

So they pay an increased margin, that's what is happening, they were at a current shelf price of 3.34 and the bonus goes up as a result of holding this. You see that at the bottom:

"An additional MPI and a bonus of £2.13 should be claimed against the above packings. Could you let me know on what date you are proposing to increase your shelf prices."

That's, I think, relating to other products. It doesn't really matter. The point is: why is this letter

being written if the position is you can have an MPI and you can be satisfied that the retailer is required to put up the price of the competitor? The reason you are spending a small fortune holding Richmond down is because Gallaher are holding down Dorchester and you need to respond.

Tab 26, an example of a Budget increase. A new schedule of costs. The document is effective from 19 March. The date you have decided to implement the Chancellor's Budget increase supersedes the last schedule. Then explains:

"Richmond is going to be hold necessitating an increased bonus."

That's at paragraphs 1 and 2. The third paragraph:

"Drum ... to be at parity with Amber Leaf: a shelf prices of 196p. This represents a 10p reduction per SKU, necessitating an additional bonus of [redacted] per outer", and then also trying to get parity on other things paying for that.

So again come back to what we are focusing on, they have a Budget causing price increases, but their competitor activity we see, it's not explicitly stated about Dorchester but that's clearly what's happening, and we can see that about Amber Leaf, is causing them to spend a lot of money to say "Well, I won't pass on the increase to you, I'll pass you a bonus" and the purpose of that is to feed through to lower prices, so entirely inconsistent with the OFT's case.

Tab 41, {D17/41}, again it's very clear you can see what's happened, that they are having to respond to Gallaher, so they have an MPI. Then they say in the second paragraph:

"We are looking to hold all Superkings brands at their current prices through the MPI. We are looking at holding them. Of course, if the market price for Sterling moves up, we would wish to do the same. However, with Sterling only just about to be launched into your business, you believe it's unlikely there would be any upward move so soon."

So at this stage they are regarding Sterling as their competitor and because Sterling's price is being kept down, they are having to pay large sums of money to keep their brands down.

Then the rest of it is dealing with forward purchasing, which I don't think is probably particularly important.

Tab 43, {D17/43}, again this is an interesting letter showing actually what happens in these relationships, on 13 August you can see in the second paragraph:

"Morrisons have joined [I am not sure, I am afraid what the MRG chorus is, I don't know if anyone else knows] and are looking to reduce their costs through increased supplier contribution."

So in other words, they are trying to get the supplier to cough up. Typically they have been quite upfront, they are expecting a pragmatic response. The bottom line is they want an additional [redacted] investment in pricing -- sorry, I won't read it out, and a further so much on the trading agreement.

THE CHAIRMAN: Sorry, what are you reading?

MR HOWARD: Sorry, 42.

Perhaps you can read it. I was just reading the first bit. What you also see here a bit further on after the middle box in the paragraphs 1 and 2 is that in paragraph 1, see what they are saying:

"An additional sum of money on all Superkings brands which are", I'll just summarise it. Those are very important because they want to break Gallaher's stranglehold on space and position; in other words, on that particular brand, this is a competitive war.

Similarly, the next paragraph, the very last paragraph, you can see questioning whether there is any money left in the trade marketing pot.

Then if you go to tab 57, {D17/57}, absolutely

clear, they publish our post Budget price lists. The first paragraph, they set out the increases in tax and what those literally mean. Then they say:

"To reflect these, we have increased all of our brands", and so on. "The only exceptions in response to competitor activity and existing price marked packs are as follows."

You then see they are going to hold down the price of Richmond and Superkings and Drum and so on, and pay bonuses. In other words, Imperial are going to absorb all or part of the cost of the tax increase in order to achieve a competitive position. Of course, all of this is completely nonsensical if what you have is an arrangement whereby your competitor's brands, because you have put up your price, are required to be put up.

Tab 63 {D17/63} is an interesting one, because what happened here -- this is August 2002 -- there was a Gallaher MPI on 25 June, initially we know that Imperial decided not to have an MPI, then they had one on 2 September. But what they decide to do when they actually introduce their MPI is that they are going to change the differentials; in other words, they have an MPI of a different amount so that the effect of this is you have, in the summer of 2002, MPIs at quite different times and of different amounts. So you see on

page 134 at the bottom:

"As you will see from our new price list, the RSP [recommended selling price] differentials have narrowed, specifically Embassy from minus 3 to minus 2", and so on.

Of course, there is absolutely no need to do this on the OFT's case, because whenever you put up your price, the Gallaher price has to be put up. What's the point of this? You will notice that the OFT, this sort of correspondence, is just ignored. No doubt Mr Matthews will be asked questions about it, and so will Mr Eastwood, and some light will be shed on how this is supposed to support the case.

Tab 68 {D17/68} is a letter which is particularly relied on by the Office of Fair Trading, by Mr Lasok in his submissions, it's 4 October 2002. You can see he says:

"As per yesterday's conversation [it's a message for Paul Giles of Morrisons from Paul Matthews].

"It looks like there is going to be some upward movement at the bottom end of the market at last.

"I would be grateful if you could make the following moves: Richmond from 3.54 to 3.59 which will mean a 213p/thousand reduction in our contribution."

A similar point for other Richmond brands.

"Wouldn't it be good if Mayfair and Dorchester followed us?"

Then something about the multipacks. And then:

"In the meantime I'll ask Graham Plummer to update the current schedule."

What is going on here, you have an end of the market, the ultra low price, where a price war has been going on, Imperial for its part has decided, because it believes that generally there will be upward movement, it's had enough and it's moving. In other words, it's giving up subsidising to the degree it has.

It then says:

"Wouldn't it be good if Mayfair and Dorchester followed us?"

In other words, I'm hoping they follow us because this will get us out of the this spiral of price cutting, but I don't have a requirement on you, Mr Retailer, to do something independently. He is just saying, you know, we hope we are getting out of this trend which is where we can't make any money because we are price cutting so much, and all it's saying is, if they follow us, that will be good.

Similarly at tab 69, he is confirming plans for Richmond multipack, and in the next paragraph, after the first sentence:

"From circa early November we will be moving to plain stock and in another attempt to move this critical sector of the business upward I would like you to adopt the shelf prices of [whatever it is], your cash margins will be maintained through reductions of [so much]."

So what he is saying "I am no longer prepared to pay as much to keep the price down, and I hope that the market generally at this end is going to move up".

I suspect if you look in the files of manufacturers of practically every single product when there are price wars where they seek to compete, they will be saying "We can't do it any more, we are moving our price up and we hope the market is going to move up. If it doesn't, you get sucked back down into the spiral. The fact that Imperial from time to time is saying "I want to get out of the spiral" is nothing, as it were, anticompetitive, that's just the reality, that they need to make money, it's not a charity that they are running.

The reason I've spent a little bit of time on this is that this central plank of the case that somehow there is some requirement or expectation or anything of the sort relating to the situation where Imperial puts up its prices is entirely contradicted by what you actually see in the documents. We haven't seen a single document here where Imperial are saying "I've put up my

price, why haven't you put up the price of Gallaher?"

What you see is entirely the opposite, which is they want to put up prices but they feel restrained and therefore they actually subsidise a holding of price because they are facing competition.

So that's Imperial price increases. If we turn our attention to a Gallaher price increase, what's being alleged here is that Gallaher puts its wholesale price and/or the selling price either as a result of a Gallaher recommendation or retailer action and nothing is done by Imperial. What one has to consider is: what then?

The OFT's case for this purpose does require you to find two things: one, that the parities were fixed, because if they were not fixed, if they are maxima, then all that happens if Gallaher's price goes up is that the differentials widen, so there is nothing wrong with that.

Secondly, you have to find that the agreement operated in such a way, or there was a practice such that there was a requirement to move the price of Imperial up so as to maintain this alleged fixed differential. The OFT's case, frankly, is wrong on both counts. I've already addressed you on the fixed/maxima point. I also pointed out to you the express provision

which is set out in agreement number 2 which actually contemplates movements upwards in prices where the bonus decreases.

If we look at the correspondence, to see actually what that shows, again we would respectfully say it all goes the other way, and so the documents relied on by the Office of Fair Trading, the first one is the letter at tab 9, this is cited both in the decision and in the skeleton. You see:

"Price Movements, L&B JPS Brands.

"I understand that Mayfair brands are moving up from Monday, 2 October. I believe this is a general increase in the multiple retailers. As discussed, could you increase the shelf price of L&B and JPS from 3.60 to 3.65 from that date. This will mean a removal of the additional retro bonuses used to achieve the lower shelf prices. As you are aware, your competitor's prices have been a little higher at 3.63, but they will also be moving to 3.65.

"We have been funding the 100 and 200 multipack positions. If you move these up pro rata, this will also mean a removal of the additional retro bonuses used to achieve the lower shelf prices."

Then he refers to Dorchester moving from 3.38 down to 3.29. Let's leave that separately. What I am focusing on is the Gallaher price increase. The price increase that has taken place in Mayfair simply provokes Imperial to then withdraw part of their margin, but what is perfectly clear from this letter is that there is no obligation on, no requirement on Morrisons to move the price of Imperial in order to achieve the parity. In other words, assume the letter is not written. Are Morrisons required to move the price up because Mayfair has moved up? Answer: self-evidently not. If you ask yourself: what would Morrisons do absent this letter? They would have actually been perfectly happy to keep the price -- well, they would have had two choices. They could have kept the price down and took the money from Imperial, or they could have put the price of Imperial up at their discretion and still took the money from Imperial. What Imperial is saying is, it goes back to the point we discussed earlier, "I do not want to carry on paying you all that money now that Mayfair has moved up with which I am trying to be competitive. I am still paying you money, it's just I don't want to pay you as much".

You have to come back to the case, there is a Gallaher price increase, was there some requirement under the P&D agreement, to move the price of Imperial? The answer is plainly not. This is asking them, telling

them that they are not going to get as much bonus any more and Imperial is perfectly entitled to withdraw its bonus.

That's basically what is happening, a withdrawal of the bonus. You remember there has been evidence that these bonuses, one of the things that you can see from all of this, the whole context of these bonuses is complicated because there are a lot of different bonuses being paid, and you have not only the ongoing ones, you have the tactical ones. Actually, what does happen in reality is that the retailers -- I mean, there is a confrontational relationship with a lot of these retailers, and there are instances where they are claiming more than Imperial thinks they are entitled to, and so they are watching each other like hawks, and partly I think it's because the margins are so low.

THE CHAIRMAN: Sorry, whose margins are so low?

MR HOWARD: The margins of the retailers are low. The margins I think of the cigarette companies are also in fact low.

THE CHAIRMAN: Well, we don't know what their margins are.

MR HOWARD: I think there is actually evidence about it, but if I am wrong, I'll check that, but I think we actually do know that the margins -- you have to actually see it, because the tax element of -- I think it's actually in

Mr Ridyard's evidence, so I'll show you that at an appropriate time. Without even looking at that, you can actually see the margins are low, in that the amount of money that is available both to the retailers and to the cigarette manufacturers is pretty low, because so much of the price that's being sold is tax.

I think I am getting slightly distracted, in this sense: we will come back to the question of what are the margins for the manufacturers, but the margins for the retailers, there is a lot of evidence you have already seen, that the margins on cigarettes are low, both in actual terms and compared to other products that they are selling. I think the evidence is that for general grocery items it's something like 25 per cent, and here you are at somewhere between 5 and 10 per cent on cigarettes.

So what one finds is, these bonuses become, particularly these tactical bonuses, which are much more significant in money terms, that's one of the things you also have to keep in your minds, that these tactical bonuses are very large indeed in comparison with the ongoing bonuses. That's where --

THE CHAIRMAN: Per pack?

MR HOWARD: Yes, but also in cash terms, in actual what is being paid to, say, Morrisons on an annual basis

under -- as a result of these -- of the bonuses, is very significant compared to what is being paid on the -- under the trading agreement.

DR SCOTT: I don't know whether we are allowed to talk the actual numbers because they are in the red box, but if you take the bottom of page 43, we can see the differential between the ongoing bonus there and the additional bonus, and if we turn the page, we can see other examples of that. What you are suggesting to us is that if those amounts are over the course of a year to be more significant, then the additional bonus has to be being paid for quite a long time, because the ongoing bonus is being presumably paid on an ongoing basis through the year.

MR HOWARD: Yes.

DR SCOTT: So you are suggesting that much of the time the tactical bonus is being paid; is that right?

MR HOWARD: Yes, that's right, they are, on different things at different -- but --

DR SCOTT: No, what you said to us earlier on was that of the money being paid as bonuses, the --

MR HOWARD: Let me just show you the documents, because this really isn't controversial. It's useful it's come out because if there is any doubt about it, look at tab 23 as an example. If you go to page 198, at tab 23, {D17/23/198}. Do you have that? You see the review of the financial year, October to 30 September 01, do you see that? If you look, ongoing dealing is nearly half a million pounds. The trading agreement is just under 100. If you look down at the notes, "ongoing dealing" includes all Richmond support post October 2001. Then what is the trading agreement is described as annualised. Of course the trading agreement sum is a payment, as I've already explained to you, which is actually achieved for being below RRP as well as being in relation to the differentials. This is a consistent theme, that the sums of money which are being paid to these retailers -- obviously one can look at it in each one -- are ...

DR SCOTT: So ongoing, on page 198, has a different meaning to ongoing --

MR HOWARD: Yes. Well, ongoing dealing there is relating to promotional activity. It's what is additional promotional activity, as I understand it.

THE CHAIRMAN: Tactical bonuses, as we have been calling them?

MR HOWARD: Yes. The reason the position is slightly more complicated in Morrisons is because the tactical bonuses get paid in a different way to in other retailers, in that in Morrisons it all gets wrapped up into the

off-invoice bonus, I don't think they separately pay it as a retro bonus, whereas elsewhere you see it separately being paid as a retro. I think that's right.

No, in fact Mr Brealey points out sometimes they do set it out as a column on those price sheets as a retro bonus. So I think that is the position.

But ongoing dealing you can see from the footnote what I am saying is right, that it's the Richmond -- it's the support which you are providing through tactical bonuses.

But the point is, that we were looking at in the letter back at tab 9, is that the OFT relies on the first paragraph that we were looking at, which is where there has been an upward movement in price, somehow to say that this shows that there is some requirement, as it were, through the P&Ds that the price should be moved up, whereas this is why you have to look at what is happening in the context of all this, the context is they have been paying a large bonus to get the price down, they see their competitors have moved up, so they are withdrawing part of their bonus.

If the OFT's case were right, firstly you would never have paid the first bonus to get your price down, and secondly you would never have any need to have this letter saying "Now I am withdrawing the bonus". The

whole thing is in a world of unreality.

Then I was going to show you an example of this situation where there is a dispute, and that's a problem. What I think I was saying to you a moment ago is these are all quite complicated, all these different financial arrangements, and you can see the retailers, they price something at 3.29, Richmond, you may say to them "after the end of May I am withdrawing my bonus so you should be going back to your previous price if you want to maintain your margin."

What sometimes happens is the retailer keeps it at 3.29 and says "I still want the bonus" and that gives rise obviously to differences, and you can see that at tab 61, {D17/61}, which is Imperial. Again we don't need to get stuck into the detail, but you can see Mr Matthews writes to Mr Giles saying he has some queries concerning retro summaries which he faxed through. Then you can see there has been a claim for Drum retros from 1 April to 21 April, which actually bears out that I was wrong in my explanation and Mr Brealey was right, that they do pay them retros for the promotional support. There is a dispute, you can see, about the volume split.

Then Superkings, which was on promotion from 22 April to 23 June, or that's their claim, and he says:

"I was quite sure I agreed to fund the 5p retro to achieve the shelf price of 3.99 until 13 May."

So he is saying it should have been 13 May, Morrisons are claiming until 23 June, and you can see in terms of what we are talking about these can be significant sums of money, and because the margins are low, for instance for the retailers, it can make a very significant difference to their margin if they priced thinking they are entitled to a bonus when they are not.

This sort of dispute also shows why it's so important and not at all surprising that in the correspondence, again that letter that we were looking at this morning, why do you refer to specific price points? Because if you don't, it gives rise to disputes. If you simply say they paid a 5p bonus to get the price down to 3.29, if you don't tell them what the consequence is of withdrawing the bonus, then there is an area, at least you can see, which is fertile ground for disputes.

Then if you go to tab 58, {D17/58}, again we are focusing on what is the effect of a Gallaher price increase. This is the part of the episode where there was a Gallaher price increase but Imperial held the price. You can see that in the middle of the page:

"As you are already aware, one of our competitors has already announced a price increase effective 25 June. This means that the differentials that exist naturally between our brands and our competitors' will widen and I would expect to see the following examples from the date you implement our competitors' price increase."

The OFT says this letter supports its case because, they say, absent this letter, the retailer would have assumed that its parity and differential requirements continued at the previously stated levels. The point that their analysis is missing is this: Imperial's case is that the differentials are maxima, they are the way everybody understands them, they are at least such and such.

Now, what Imperial was saying here, because Gallaher has increased the prices and we are not, and what they are saying is "we don't want you to use the cloak of Gallaher's price increase as a basis to increase our prices, albeit you could do it and maintain the differential, so I am actually widening the differential".

If you say: what would have happened absent this letter, was there a requirement to increase Imperial's price, plainly there was no requirement, but that doesn't mean that the retailer might not have sought to

do it and still claim the bonus. So what Imperial is trying to say is "I want a wider differential", and that is explained by Mr Matthews as well, and you will hear from him.

THE CHAIRMAN: So you are saying that there was a bonus underlying this letter?

DR SCOTT: No, there didn't need to be because they hadn't done an MPI.

THE CHAIRMAN: No, but I thought you just said a moment ago ...

MR HOWARD: It's the ongoing bonus which is the subject of the trading agreement.

THE CHAIRMAN: Oh, I see, yes.

MR HOWARD: Insofar as what they are trying to do is incentivise them to have differentials, what this is saying is "we want to widen the differentials", that's all it's saying.

DR SCOTT: For reasons that you think are probably obscure, they did bother to have a trading agreement. The other side of the coin, that you are saying, you are saying all this correspondence shows that there wasn't a requirement in the trading agreement.

MR HOWARD: Yes.

DR SCOTT: But in fact there was a trading agreement.

MR HOWARD: Yes.

DR SCOTT: Now, the fact that there was a trading agreement, whether they were fixed or maxima or P&Ds, let's not worry for the moment, but there were some P&Ds around. What this letter looks like in the context of there being a trading agreement was: we had a schedule of P&Ds, A, Gallaher have moved, we don't want to move, so we have a new set of P&Ds, which if we are in the trading agreement world is where we would like to be and as I understand it, in strategic terms is where Imperial want to be; is that right?

MR HOWARD: Yes.

DR SCOTT: So I am not quite sure why this letter counts either way, really. In OFT's case they see it as a natural consequence of there being a trading agreement.

MR HOWARD: Yes.

DR SCOTT: In your case, you see it as a natural consequence of the trading agreement not containing a requirement.

MR HOWARD: In my submission, you are entirely right, and that's what I said to you in opening about the June episode. The OFT relies on it to say: this shows that if you hadn't written this letter, there was a requirement, and that the prices of Imperial would automatically go up as a result. We say that's plainly not what is happening, that what -- if you don't write

the letter, the retailer might choose to put up your price and still say, insofar as he is interested in it, "I am complying with the differentials". What the letter is intended to say is, as Dr Scott, you said to me, it's intended to widen the differentials, but it's not inconsistent with the fact that if you don't write the letter, there is no requirement to put up the price. What it's actually trying to do is just simply widen the differentials.

So it doesn't -- I would agree with you -- shed a great deal of light on the position other than it is entirely consistent with all the correspondence I've shown you as to actually the nature of the arrangements. But it's the OFT in particular that say this episode -- it's in the decision at paragraph 6.790 -- confirms their case, and it simply doesn't. If one is going to analyse it, it actually is inconsistent.

It's just convenient at this moment to interpose, so we have looked so far at the supposition of the OFT's case that if Imperial puts up its price, the retailer was required to put up the price of Gallaher -- I hope I have demonstrated that that plainly isn't the case -- then looked at the situation where Gallaher puts up its price and the supposition that Imperial expects its price to go up; and again that's not the case.

You feed into that, just before we look at the other two situations: does it make any economic sense to think that the retailers were obliging themselves, because Imperial put up its price or Gallaher put up its price, to move up the price of the rival brands? Now, this is partly where the economic analysis fits in, that it doesn't make any economic sense at all, that the sums of money which the retailers are standing to make are not sufficient to compensate them for the potential losses they suffer, and if you particularly think of Morrisons, Morrisons are very concerned about benchmarking themselves against their competitors. If they are put in a position where they are obliged to move Gallaher's prices up, or Imperial's prices up, where the wholesale price of those products hasn't been moved up, then it would be obvious to them, "Hang on a minute, I will be disadvantaging myself in the market, that would not fit with my strategy". There is just no way that, for the sums of money at issue here, they would have agreed to that. That's set out in table 2 of Mr Ridyard's second report.

DR SCOTT: That seems to be so, unless, as we have seen in at least one of the letters you have shown us before, they received some comfort from ITL that their competitors were going up as well.

MR HOWARD: Yes, but you have to remember, again that's why you have to be quite careful as to -- there that's a letter, firstly, where ITL is saying "We understand that [that was, I think, talking about Gallaher's price going up] in the market they are going up and we are therefore withdrawing our bonus". But you have to remember the case that's run against by the OFT is where the Gallaher price has gone up, the retailer ipso facto moves up the price of Imperial, and -- of course he may be perfectly content to do it when he knows or believes actually that the market is moving up, but the OFT's case is he's required to do that irrespective of that position. That's the important point.

Now, Imperial price decreases, one can deal with that pretty shortly, and I don't think I need to turn up the documents. You will remember, for instance, the story about Richmond coming down, them spending 10p per pack of Richmond to get its price down. Just ask yourselves as a matter of common sense: did Imperial require the retailers -- when they were throwing all this money at Richmond, in order to make Richmond competitive -- to reduce the price of their competitors' brands? It's just completely nonsensical. That argument is suggesting that there is a big black hole over there where Imperial likes throwing its money.

The OFT's case does actually require one to apply some commercial sense to it. We have been interested, so far, in relation to a lot of the points to find that none of the witnesses so far have been asked anything to do with this, and we will see whether Mr Matthews is asked whether he was spending Imperial's money in a situation where he expected to achieve no advantage at all.

Now, that takes me to Gallaher's price decreases, and this is important in relation to the suggestion that Morrisons were restricted from favouring Gallaher. This is part of the point we discussed yesterday, that the trading agreements expressly envisaged that Morrisons would reduce the prices of competing products as a result of Gallaher taking action, or it could be BAT for that matter. How do we know that? Because the opportunity to respond clauses don't make any sense at all if you are not contemplating that they would do that.

Now, a number of the documents we can look at show this taking place. Tab 9, {D17/9}, one we looked at before, the second part of the letter, you will see that Dorchester will be moving from next Monday down from 3.38 to 3.29. Mr Matthews says:

"You believe that it's a temporary move. Following

the announcement to the trade last Monday, the RRP of Richmond has been reduced by 10p. Our strategy is parity. As agreed, I am willing to maintain your cash margin at the same shelf price as Dorchester. Please reduce the brands on the same date that Dorchester goes down."

What you see is that they end up spending, if you go to the second page, they are already heavily bonusing at 3.39, because there was an additional bonus of £3.80, and to get down to £3.29 they have to pay an additional £2. Plainly none of this makes any sense at all on the OFT's case. The OFT's case is the retailer has bound himself to reduce the price of Richmond in order to maintain parity. What's more, they are so nervous about the position and so uncertain that they also say -- you see this in the paragraph on the second page:

"Justin, I have assumed a shelf price of 3.29, but as you are currently 3.38 on Dorchester ... you may be selling it at 3.28 ... If this were the case ..."

"I want to go to that and I'll pay you even more money"; in other words "I am prepared to spend even more money to match my competitor".

Tab 50, {D17/50} again Imperial cuts the price. If you see the whole letter, they are cutting the price of some cigars. In other words, they are increasing the bonus on them. Then Cafe Creme they say:

"During our conversation we also agreed to bring down the price of Cafe Creme and Cafe Creme Mild multipacks to be in line with Hamlet with a shelf price of £13.10 and the schedule of costs has been amended in accordance with these changes."

In other words "I am going to pay you more money and that's what the schedule of costs has, it's on the next page, it increases the amount of money they get.

The OFT cites document 53 as somehow being supportive of their case. Again, properly read, it's entirely inconsistent. The email at the bottom is talking about the movement in the price of Amber Leaf, but you can pick it up, really, the important part, in the reply:

"Ref our earlier conversation, yes, I would like to match Amber Leaf across all the SKUs. As well as the move on 12.5, I would like to move to 25 [and so on] and 50. All coming down [so they are moving the price down]. This will necessitate increases in bonuses of these sums of money", considerable sums of money.

So they are aware of the fact that Gallaher are heavily promoting Amber Leaf, and they reacted to it. So what you see is there is no requirement of the retailer at all, and what's more, you have a competitive

position.

Tab 59, {D17/59}, again it's a familiar sort of territory.

"I understand one of our competitors decided to reduce the RSP of Amber Leaf. Whilst I would prefer to keep more cash in this important subcategory, I need my brands to remain competitive."

Just stopping there for a moment, again there is absolutely nothing wrong with his saying "We would prefer -- in relation to I think this is roll-your-own, isn't it -- in this important category to try and make more money, but we need our brands to remain competitive, so we are going to respond and react to what they are doing by shelf price reductions and increases in bonuses"; in other words "we will fund the shelf price reduction".

Again, a similar point in relation to Drum Milde and so on.

Then he says he is not sure why Cafe Creme are out of line with Hamlet Miniatures, which must have been held following the Gallaher MPI. So he sees what's happened is Gallaher had an MPI but obviously unbeknown to Imperial they seek to steal a march, which of course they are entitled to do, by holding down the price of theirs, so then he says, "Uh-oh, if they are doing that,

then I want to get Cafe Creme down to £12.99 and I'll pay you for it as an increase in the bonus. Again, could you move Panama 6s to 2.69 because I am going to pay you for it".

What is wrong, one has to ask, with Imperial paying to get the price down?

Now, what is said by the OFT about this document, is they say that this is manipulation of Morrisons' retail prices through the payment of bonuses and it's consistent with the existence of the infringing agreement. That's paragraph 6.804. It's difficult to understand what the case is that's being made. What do you mean by "consistent with the existence of an infringing agreement"? You have to first prove that there was an infringing agreement. To say manipulation of the prices, as I think you have heard, and it would be astonishing if it wasn't the case, when Unilever see the competing price of the washing liquid at a particular price, one can be absolutely sure that they are writing saying "Well, we will pay you, Mr Supermarket, to get the price of ours down in order that we can compete". To say that you are not interested in the selling prices would be very surprising.

Now, this leads me back to the point that I think

arose just before we broke yesterday, when Madam Chairman suggested to me that one of the issues that the Tribunal will have to decide is whether the tactical bonuses are one of the mechanisms by which the parities and differentials are maintained or enforced, or whether they are a manifestation of strong price competition and brand positioning quite apart from the P&Ds.

As I said earlier this morning, we don't believe that this is really the issue in the case, in that if one just analyses it as follows: firstly, we say on the evidence none of the retailers in fact regarded themselves as obliged to apply the P&Ds, and we say nor were they, and that the payments were an incentive. But more importantly, the agreements always recognised that they would be entitled to have Gallaher price promotions or BAT price promotions.

Where Morrisons chose not to follow the P&Ds, and so Imperial found itself in a less advantageous position, Imperial was free to seek to induce Morrisons to then reduce the price of Imperial's products to its advantage, and that's what you see happening, it's trying, when it finds it's out of line with where it wants its selling prices to be, it seeks to pay money to get to where it wanted to be.

If you are asking the question: when Imperial sought to pay further monies to Morrisons in order to rules the shelf price, was it seeking to pursue its strategy of positioning its products in accordance with the strategy? The answer is: yes, of course it was. No-one suggests it wasn't. In other words, generally the purpose in the tactical bonuses was indeed to achieve the differential position that accorded with the strategy. There is nothing sinister or unusual in that. The fact that it's pursuant to that strategy does not mean that it is not the manifestation of strong price competition, and more importantly it doesn't mean that it is anticompetitive. Indeed, one can't think of anything that is much more competitive than what we see in these papers.

In other words, there is no dichotomy between seeking to achieve or maintain the price differentials and normal competition. Moreover, the payment of the promotional bonuses is not evidence of some -- and this is what you have to keep coming back to -- restriction on Morrisons here to prevent them favouring Gallaher. You can just test that very simply.

The fact that Imperial pays a promotional bonus in order to achieve a pricing position of its product, whether at a specific or maximum price it doesn't matter, which accords with its strategy, doesn't stop

the retailer then favouring Gallaher. It just means that Gallaher, if it then wants to get into a more favourable position, has to come along and say "Mr Retailer, take some more money from me". In other words, competition in action.

Now, if Gallaher wants to do that, then it will do it. If Gallaher decides it's not worth it, it won't. And the same you see with Imperial. Sometimes it decides to try and meet Dorchester and sometimes it says "The game is not worth the candle and I am going to withdraw my bonus".

So the fact that Imperial has a strategy which is to get its cigarettes competitively priced vis-a-vis Gallaher is not in contrast to a strong price competition, it's a manifestation of strong price competition, and indeed we would suggest when you look at price promotions you can see the following things. Firstly, it's obvious when Imperial leads a price promotion, it does not intend the retailer itself to reduce the price of Gallaher's product, otherwise what's the point? It of course has the risk that Gallaher will seek to match it, but that's the risk in any competition situation, that's what competition is all about. So when Imperial pays a tactical bonus, it's taking a competitive position.

Secondly, when Gallaher leads, firstly Gallaher obviously does not intend the retailer, when it puts -- we are not going to hear any evidence from Gallaher, one can infer Gallaher did not intend when it put down the price of Dorchester that the retailer would put down the price of Richmond just because Gallaher had done so. It knew presumably there was a risk that Imperial would respond. It no doubt crossed its fingers and said "I hope they don't", but it always knew there was a risk.

Secondly, Imperial, as you have seen from the correspondence, obviously did not understand the retailer must put down its price because Gallaher has put down its price, otherwise why is it spending a small fortune on trying to get its prices down? So Imperial is just responding to a competitive position, and the tactical promotions are just classic examples of price competition.

What's actually interesting in all of this is that because the retailers actually know what Imperial's strategy is, they can actually use that, and they did, to what Professor Shaffer calls parlaying the prices down. You have seen it before in his 2007 report, paragraph 53. Because, as it were, they know the vulnerability of the manufacturers, they can use it to

say "Well, Dorchester is down, that may be something that they themselves have done, but you know Imperial, if you want to be competitive, you are going to have to cough up", and again all of this is things that are pointing to prices coming down as you would expect in any price war of the type that we see.

It's also clear in the case of these tactical promotions that what Imperial is seeking to do is to pass through from the bonus, ie a lower wholesale price, to a lower selling price. That's the purpose of actually the way the bonuses are structured. That is revealing because it's precisely in fact also what the purpose is from Imperial's perspective of the P&Ds. They are seeking to incentivise what they perceive to be the position, which is lower wholesale prices being reflected in lower selling prices. They know that if in fact their wholesale prices are not lower, then they won't actually incentivise through these agreements and they will have to pay more money, and that's what happens with the promotional bonuses. When they find that the retailer is choosing to price them at a disadvantageous level, their response is: Mr Retailer, I'll give you some more money.

The very fact that Imperial needed to pay tactical bonuses to remain competitive with Gallaher, we suggest entirely undermines the theory of harm put forward by the Office of Fair Trading, because if the agreements or practices that operated in the way that the Office of Fair Trading suggests, you just never see any of this correspondence, because the case that the OFT makes is that the retailer, here Morrisons, is precluded from favouring Gallaher.

We do suggest that -- and it is really quite important, this -- the Office of Fair Trading does not really have an answer to this point. It is interesting, and again to contrast what Mr Lasok said when he opened the case with what he actually suggests at any stage to any of the witnesses what he seeks to extract from the documents. If you look at Day 5 of the hearing, at pages 32 to 34, it might be just worth turning that up.

THE CHAIRMAN: Is this really a point in the opening of the Morrisons case? This seems to be rather getting into more general submissions on the case.

MR HOWARD: It is in this sense, we don't need to turn up that point, but what -- the point that Mr Lasok made was that the commercial reality, he says, is that -- what he was looking at was how the opportunity to respond clause is working, and he says, well, the retailer -- these were his words, it's likely to be a little bit sticky, you remember this expression he used, and he may not

want to move the price, and somehow the fact that you are then paying them, somehow they say this fits in. The point is, the issue that needs to be put to the witnesses is whether that is actually the case at all, whether when the bonuses here are being paid to Mr Eastwood, was it the position where he was a bit sticky that he was being expected to move the price and he wasn't prepared to do it unless some money came his way? When you look at this correspondence, actually there is not a hint of that sort of situation.

To conclude, I started yesterday by saying what actually happened in this account, and I took you to tabs 1 and 96. If you remember, what those show is a growth in Imperial's market share in Morrisons, and to respond to the point that Dr Scott asked me, was that, as it were, like for like growth or was it as a result of acquisitions? During the period that we are talking about, there were some acquisitions but they have nothing to do with the UK market, I think there was some acquisitions of businesses which are outside. Insofar as the Philip Morris position was acquired by Imperial, you can see at tab 96 {D17/96} that the effect of Philip Morris is broken out, so you can see that the point I was making is on the like for like basis, the Philip Morris position takes it even higher.

So the fundamental point is that you see what is actually happening here, which is through what is actually largely a very keen competitive position as to price, particularly in this ultra low price area, which was a particular feature of Morrisons, that Imperial was able to grow its market share.

The only other point I would remember to refer you to is the variability data again is entirely inconsistent with the OFT's case.

THE CHAIRMAN: Yes, thank you very much. We will take a break now and come back at ten to 12.

(11.40 am)

(A short break)

(11.50 am)

THE CHAIRMAN: Yes.

MR HOWARD: Yes, we call Mr Matthews.

THE CHAIRMAN: Yes.

MR PAUL MATTHEWS (sworn)

Examination-in-chief by MR HOWARD

MR HOWARD: Mr Matthews, could you just please tell us for the record your name and address?

A. My name is Paul Matthews, my address is [redacted].

Q. Thank you. Could you now be, if it's not on the table in front of you, given core bundle 3, and turn to tab 42, please. {C3/42}. At tab 42, is that your

statement?

A. Yes, that is my statement.

Q. Are the contents of that true?

A. Yes.

MR HOWARD: Thank you very much.

THE CHAIRMAN: Yes, Mr Williams.

Cross-examination by MR WILLIAMS

MR WILLIAMS: Good morning, Mr Matthews.

A. Good morning.

Q. Have you read the transcript of any of these proceedings so far, the day-to-day transcript?

A. I was given some notes last week for one day, which I glanced at, yes.

Q. Do you remember what day that was or what happened on that day?

A. I think that that was the day that an ex-colleague of mine, Roger Batty, was at the Tribunal, so I think it would have been at the beginning of last week, perhaps.

Q. You have your statement in front of you?

A. I do.

Q. Could you also be given annex 17, which is -- do you know what annex 17 is?

A. Erm --

Q. It's a file of documents compiled by the OFT in relation to Morrisons and ITL.

A. Yes, yes.
Q. I think it would be useful for you to have both your statement and that file open.
A. Okay.
Q. Could you turn to tab 85, please. {D17/85}. You are familiar with this document, I think, it's the ITL/Morrisons trading agreement which applied from August 2002?
A. I am familiar with this.
Q. You took over the Morrisons account in September 2000?
A. Yes, that's correct.
Q. So you managed the Morrisons account for the whole period we are looking at here, more or less?
A. Yes.
Q. You worked with Morrisons both under this trading agreement and under the previous one?
A. That's correct.
Q. I have been working on the basis that you wrote this document, effectively.
A. Yes, I did write this document.
Q. We see over the page, actually, that you didn't sign it at the time, but I don't think there is any significance in that, I just note that for the Tribunal.
A. I think I did sign it.
Q. Did you?

A. Yes, that's my signature there, signed on behalf of Imperial Tobacco --
Q. I am sorry, I had not separated that from the other signature.
A. -- Limited. It doesn't look like a signature, but I can promise you that is my signature.
Q. So just looking at the first page of the document, we see under the heading "Payments", there is a certain sum of money that ITL agreed to pay Morrisons per annum for the two years of the trading agreement?
A. Yes.
Q. If we turn over the page, you will appreciate I am just going to focus on the section about pricing at the moment, do you want to read to yourself just to refresh your memory the first two paragraphs under "Pricing".
(Pause)
I am just going to break this down into its various elements at the moment, hopefully in terms which are uncontroversial. ITL has a pricing strategy which has two aspects, first the achievement of certain differentials between ITL and Gallaher brands; and secondly, the achievement of certain absolute price levels.
A. Yes.
Q. Under this agreement, you say you are investing in

Morrisons which means you are paying them a bonus to achieve that strategy, and that's the bonus we have just seen or some part of it?
A. I am not sure if I am permitted to say this, and I understand that the pricing element is important, but I would like to say that the agreement should be considered in a holistic way in that it covers more than just pricing. I think I might be wrong, but those monies we referred to just a moment ago do cover more than that.
Q. They do, yes.
A. Quite a lot more than that.
Q. Yes, but just to go back to the question I asked you, and really I was just reading the words under the heading "Pricing" --
A. Yes.
Q. You have a strategy in relation to pricing and you are investing in Morrisons, that is paying them a bonus to achieve your pricing strategy?
A. Yes, there is a pricing strategy, yeah, and there is a payment for that.
Q. In your witness statement, you talk about ongoing bonuses and tactical bonuses?
A. Yes.
Q. In that terminology, the bonus paid for these two

elements of the strategy would be ongoing bonuses?
A. I think it's probably worth just -- perhaps you could ask me that question again, so I am sure.
Q. In your witness statement you talk about ongoing bonuses and tactical bonuses?
A. Yes.
Q. All I was saying is that I think in that terminology the bonus that you are paying here would be an ongoing bonus?
A. Well, it's both, because it covers two different things. They are two quite separate things, ongoing and tactical bonuses.
Q. That's right, but I am just saying that when you talk about an investment in Morrisons --
A. Yeah.
Q. -- I really don't think this is controversial but you can tell me if I am wrong, I am just trying to get the terminology right, when in your statement you talk about ongoing bonuses and tactical bonuses, I am just saying the investment you are talking about in these two paragraphs would be an ongoing bonus rather than a tactical bonus, but please do tell me if that's not right?
A. (Pause). I mean, the ongoing schedule of costs, bonuses and margins document could, from time to time, include

the provision of both ongoing and tactical bonuses. Perhaps I am misreading or misunderstanding the question.
Q. We will come to that in a minute.
A. Okay.
Q. I think you are right about that. Just focusing on the bonus paid to maintain differentials, would you describe that as an ongoing bonus?
A. It could be either.
Q. We will look at the detail of this in due course. So focusing on the absolute levels of prices for a minute, what the agreement says is that you will pay a bonus as long as Morrisons puts its shelf prices at the levels stated in the ongoing schedule?
A. I think that, again I hope I don't dwell on this point for too long, but the payment of absolute bonuses or ongoing bonuses I should say was to reflect the fact that Morrisons, like many other supermarkets, were selling tobacco products very cheaply. In the spectrum of prices, they were towards the bottom, and these payments were made to recognise and reflect the fact that Morrisons and other supermarkets made investment in our brands, and that we too should contribute to that whilst they continued to remain retailers that offered our brands at an attractive price.

Q. Can we just come back to what the agreement says, I'm focusing at the moment on the second paragraph, it says:
"Based on the continued achievement of [skip out differentials for the minute] the shelf prices highlighted in the ongoing schedule of costs, bonuses and margins, Imperial will pay all of these bonus off-invoice subject to the following conditions."
A. Right.
Q. You can see two points, really. First of all, there is a reference to off-invoice, which is why I thought this was a reference to ongoing bonuses rather than tactical bonuses.
A. Right.
Q. But the specific point I was making was just that the words here say that based on continued achievement of the shelf prices highlighted in the ongoing schedule, you will pay them a bonus?
A. But those shelf prices highlighted in that or any schedule could be subject to both ongoing and tactical bonuses because in order to reflect those differentials, it might require more than an ongoing payment, and I do think that it's important to separate those two for that reason.
Q. I think we are separating them. At the moment I am just talking about one of them. I am talking about the

provision this agreement makes for one of them.
A. Right.
Q. Again, I don't think it's controversial, but you can tell me if I am wrong. The agreement says:
Based on continued achievement of the shelf prices highlighted in the ongoing schedule [you] will pay them a bonus."
So you are paying them a bonus to price at the levels in the schedule?
A. We are paying them the ongoing bonuses for two things, for firstly -- sorry if I repeat myself again, but for two things. Firstly, to reflect those prices were below RRP and secondary to that, to achieve those differentials. Sorry to dwell on the point, I just thought it was worth making.
Q. But that's really the point I am making to you, that this agreement doesn't talk about pricing below RRP, it talks about pricing in accordance with the schedules?
A. You are absolutely right about that, and I think that that's an interesting point because these agreements in general terms were written by national account managers and buyers, I hope this isn't the wrong thing to say but they weren't supposed to be legally binding, they were framework documents that couldn't be written given every possible eventuality, but implicit within the trading

relationship as well as the trading agreement was that Morrisons would continue to support our brands by selling them beneath RRP.
Whilst it doesn't say that specifically, that was very much the understanding between ourselves and between Morrisons.
Q. You could have written an agreement saying "We will pay you a bonus as long as you price below RRP", couldn't you?
A. I could have done that, yes.
Q. But you chose not to. You have provided for them to pay on the basis of the schedule?
A. Well, I chose not to do it, I suppose I did choose not to do it, because at the time of writing it, I think it was fairly plain to both parties that one of the only reasons that Morrisons like many other supermarkets was in the tobacco business was that they were able to provide cigarette brands cheaply, and I think it would have been unnecessary to say so, because that was their raison d'être within the category. If they had sold brands expensively, there would have been no reason for people to tear themselves away from their local newsagent and visit Morrison to buy tobacco products.
Q. So why would you pay them a bonus to price below RRP, then?

A. Because in the UK the market structure dictates that margins are relatively slim and they were made slimmer still by Morrison, or indeed any of the supermarkets, electing to sell their brands quite cheaply. So they might well find themselves working on margins of 1 or 2 per cent, particularly on the cheaper brands. We recognised that that was within our interests, and within the interests of our consumers, and we wanted to recognise and reward that, hence the continued payment of ongoing bonuses which were quite separate and quite different from tactical bonuses.
DR SCOTT: Just to be clear, then, the margin that you just mentioned of 1 or 2 per cent is the margin before the application of your margin support; is that right?
A. I'll be very careful what I say, because my memory isn't as good as it used to be, but even including bonuses on the cheaper brands, they might well -- some of the supermarkets worked after payments on 1, 2, 3 per cent, that wasn't unheard of.
DR SCOTT: We will no doubt come to what the margins were in the documents, but it's getting clear whether, when you are talking about these margins, you are talking about the net price including all the bonuses or the price which is on the invoice distinct from the off-invoice bonusing?

A. I think I would be on safer ground if I was to say that if an RRP was £5, that a supermarket would want to be well below that, which mathematically would mean they would make a much smaller margin, dependent on brand, and because of that and our recognition of that we would make investments to support it. So effectively those ongoing monies were there in margin support, margin enhancement, and I think that was very much the understanding, and because of that and because Morrisons were in the category to provide cheap products, writing "because you are selling beneath RRP" was just unnecessary.
THE CHAIRMAN: So you are saying that because of how Morrisons saw themselves in the market they wanted to price below RRP and in recognition of the fact that that was also in ITL's interests, you gave them a better wholesale price?
A. That's a much more succinct way than I put it. Exactly right, yes.
MR WILLIAMS: I think what I am putting to you is that you didn't need to pay Morrisons a bonus to price under RRP and so you didn't, but you chose to pay them a bonus for something else, which was pricing in accordance with the schedules, which is what this says.
A. I am afraid I can't agree with that.

Q. Moving on to the differentials, what this says is that the payment of the bonus for that is based on continued achievement of the differentials. So they have to achieve the differentials to get the bonus?
A. That is definitely the aspiration.
Q. We have covered this already to some extent, but ITL also paid Morrisons tactical bonuses to bring about compliance with differentials?
A. We paid tactical bonuses to reflect a period of time in the industry when there was a huge battle for market share. This period here was hallmarked by the end of traditional advertising, and when price became the major weapon in our artillery. So during this period we would make tactical bonuses to try and compete with brands that we saw as competitor brands so those bonuses were paid for that reason.
Q. Sorry, I didn't mean to say anything controversial, I was just summarising the first sentence of paragraph 124 of your witness statement. Do you want to have a look at that?
A. 124?
Q. Yes.
A. Okay.
Q. This is a point you make in the context of a specific example, which we will look at in a minute, but if you

just read that to yourself.
(Pause)
You can read the paragraph, but it's only the first sentence I was focusing on.
A. 124, perhaps I am looking in the wrong place, this is a reference --
Q. Paragraph 124, "My email to Morrisons"?
A. I see, I am in the right place.
Q. You say:
"[This email] provides an example of ITL increasing margin support [which I think is a tactical bonus] to reduce the shelf price of an ITL product to maintain the differential with a competing product."
A. Yes.
Q. So all I was saying was that you would pay a tactical bonus in order to maintain a differential?
A. We would do.
Q. This is contemplated in the agreement in the first bullet point underneath the two paragraphs we have just been looking at. Do you want to just read that to yourself?
A. Yes. I've read it.
Q. Okay. So this is what we have called the opportunity to respond clause, I don't know if that terminology is familiar to you?

A. Yes.
Q. The opportunity to respond clause is explained in this agreement as a mechanism for enabling ITL to realign the differential that it wanted to see if Gallaher reduced its prices?
A. Yes.
Q. Just to put this in the context of the pricing strategy that's described in the first two paragraphs, ITL has a strategy to achieve certain differentials, a price reduction by Gallaher might disturb those differentials, and this clause or this mechanism gives you an opportunity to realign the differentials by paying a tactical bonus?
A. Well, I think that's absolutely right. We wanted the right to respond, because we knew that those differentials might change from time to time, because of the competitive nature of the market.
Q. But is that the differential changing? Sorry, that's the differential in the shelf price changing rather than the differential, for example the price list differential? In that situation the price list differential wouldn't necessarily change; what's changed is the differential in the shelf prices?
A. It could be for a lot of reasons, and some of them aren't completely explored there, but should our

competitors choose to reduce the price of a product because they felt it would give them advantage, or perhaps the supermarket themselves might decide that they wanted to make a product they felt was important cheaper, and I think this was a sort of catch-all to say "Look, we have aspirations in pricing, but you know, we don't live in a perfect world and should there be opportunities for us to correct those through investment, we would like that opportunity".
Q. It's interesting you say that, because what the clause says is "Should our competitors reduce their shelf prices", so you contemplate that Gallaher will reduce their shelf -- Gallaher amongst others, I should say?
A. Yes.
THE CHAIRMAN: Let's just check, because there are two parties to this agreement, Morrisons and ITL and their competitors, is that the competitors of ITL or the competitors of Morrisons?
A. Well, I think that the only thing I knew was that from time to time my competitors, the manufacturers would want to attack my brands, but clearly I wouldn't have known the strategy of the supermarket with their competitors, which is, you know, why that wouldn't have been included in there, but that eventuality would be part of a tactical bonus.

MR WILLIAMS: So you are saying that you might pay a tactical bonus -- and we will come back to exactly what that means mechanically in a bit -- in order to fund a supermarket's desire to compete with its own competitors; you would pay money to enable them to do what they wanted to do?
A. It was a source of tension. There would be the Monday morning phone call from Tesco "I have just been to Asda and I've seen that they are selling Lambert & Butler at 3.89, I want to do the same, where is the money? You have until Friday afternoon to respond". So that became quite a frequent piece of conversation, and clearly Morrison as a competitive retailer would have a similar view, maybe they thought that they ought to be at the same price as Asda and they would frequently ask for investment. Sometimes you would make it, if you felt you could get something else. Other times perhaps you wouldn't be able to match what they required.
Q. Can I just probe that because if they came to you and said "Tesco are having a promotion, we don't know whether there is any bonus on that but as far as we are concerned, it's just something they have done on their own, they decided to reduce prices, it's a Tesco driven promotion, and we want to match that, so can you pay us a tactical bonus", if they put it to you in those terms

would you be minded to pay them a tactical bonus to allow them to compete with their competitor?
A. That was part of the game. A good buyer would persuade you to make that investment for a range of reasons, and there would be supposition, bluffing, brinkmanship in all of it. You would be less inclined to want to make that investment, but they were made from time to time. I have made similar investments.
THE CHAIRMAN: Less inclined to make that kind of investment than you would be inclined to make an investment when the reduction reflected a Gallaher investment?
A. Yes, I think that would be correct.
MR WILLIAMS: Are you really saying that if a retailer came to you and said "Look, Tesco is doing its own thing, we want to compete with Tesco but we don't want to take that out of our own margin, we want you to take that out of your own margin, so can you do that please", that's a proposition you would entertain?
A. It's certainly one that would be considered. I hope I am not overstepping the mark by saying that that is how the buyer and seller relationship works in supermarkets generally.
Q. That is not a situation of bluff, I am not talking about a situation of bluff, I am talking about a situation where what's being proposed is that you fund a retailer

driven promotion.
MR HOWARD: How is it suggested that anybody knows when Tesco reduces its own price whether Tesco is doing that of its own accord or whether its being funded by the manufacturer? Perhaps that could be made clear in the questions.
MR WILLIAMS: I am just responding to something Mr Matthews said, which was that if the supermarket wanted to do a promotion of its own, that's something we might pay a tactical bonus for, so I am just asking questions about the evidence that Mr Matthews has given.
THE CHAIRMAN: Yes. Mr Matthews is saying they don't need to know the answer to that question before they consider whether to respond.
MR HOWARD: I think Mr Williams' question was on the premise that Morrisons will come along and say "Tesco is funding out of its own pocket a reduction", and I would ask him to make clear on what basis Morrisons would ever know the basis on which Tesco was 2p lower. The answer is they would never know. So all they can come along and say is "Tesco are lower". That's a fair question, what do you do there.
THE CHAIRMAN: Let him ask the question.
MR WILLIAMS: I think all I am trying to get at, Mr Matthews, is whether you would entertain a request

for tactical funding for something which you knew or believed to be a promotion which the retailer was choosing to engage in?
A. I have made investments like that within Morrison, yeah.
Q. We will come back to an example of a situation a bit like this in due course, but we will leave that there for the minute.
Coming back to the opportunity to respond clause, I think we had agreed on some of the mechanics and what's broadly going on there. What I want to come back to is the context for this, really, which is that margin, retail margins on tobacco products are thin, if you want to reduce shelf prices in order to compete with Gallaher, you don't expect Morrisons to take a hit on its margin and so you pay a bonus which means that it doesn't lose margin by reducing prices to whatever level it needs to be set in order to achieve parity?
A. Yes.
Q. Sorry, the question was a bit longer than I intended, but I think we got there.
A. I understand.
Q. When you talk about paying a bonus here, it's really a contingent reduction in the wholesale price, isn't it? You are not actually paying them money?
A. A contingent reduction in the wholesale price?

Q. So you have a particular wholesale price and you apply a retro bonus to the wholesale price which effectively brings the wholesale price down on the basis that they price at the level you want them to price at, you are not positively paying them money, it results in a reduction in the wholesale price?
A. Well, their landed price, their net price would be what they bought from either direct or through a third party, I think Morrison at the time were buying directly, and I am not sure I appreciate the point completely, I mean, how the Budgets and the Treasury piece worked I am not sure, but we would pay money, it would cost us money to make these investments.
THE CHAIRMAN: In some instances with other retailers we have seen that a separate invoice was raised for the payment of this bonus --
A. I see.
THE CHAIRMAN: -- whereas what's been put to you is that that's not the mechanism, the mechanism in this retailer was a reduction in the wholesale price?
A. It was. There was a time when the payments weren't made off-invoices and they were raised separately, but one way or another it had the net result of reducing their buying price.
MR WILLIAMS: In the situation that we have just been

describing where you want to react to a reduction in price by Gallaher, is it right to say that there is no obvious reason why Morrisons would turn down the bonus that you are proposing?
A. They might, and if you ask me specific to Morrison, it's unlikely, but I can think of times when they played hard to get.
Q. Broadly speaking, you could expect to be able to restore the differential by offering a tactical bonus?
A. As long as you were able to maintain cash margins, I think it was pretty likely that from time to time a buyer would say "Look, you know, how low do you want to go? You are taking cash out of the till, so turnover is being affected". So dependent on how they were feeling on that morning they might negotiate a bit harder than they needed to.
Q. I am not sure, was that a "broadly yes, but"?
A. "Broadly yes, but", but it's not black and white.
Q. The second sentence of this bullet point about the opportunity to respond clause says:
"Should any additional funding be agreed to support a response to the competitor activity, it should be removed once that activity has ended."
Applying the same sort of "broadly" approach, broadly speaking would you accept Morrison's shelf price

to come back up to the unfunded level when you reduced the tactical bonus?
A. You would hope that it would, but again that isn't black and white either because a buyer might say "I forgot to change the pricing last week, I can only do it every week, it's gone another week, is that okay, Paul?"
So even within the negotiation there would be negotiation, so you would hope that it would, broadly, yes.
Q. Would that be a negotiation about the date on which the bonus finishes, or would that be a negotiation about whether they reduced prices when you reduced the bonus?
THE CHAIRMAN: Whether they would increase prices --
MR WILLIAMS: Thank you madam.
A. It would be the former, I think.
Q. So once you turned the bonus off, you would broadly expect them to come back to the unfunded level?
A. You would expect that to happen.
Q. Given that it was your strategy to maintain certain differentials, as we have seen recorded in the agreement, would you agree that it was usual for you to offer a bonus to maintain the differential in any given case falling within the strategy?
A. I would say it was usual but it wasn't binary in that there were examples where we didn't want to -- we

couldn't afford or didn't want to follow price reductions.
Q. We are going to look at an example of this now, but before we do that can we just look at the right-hand side of the agreement.
A. Yes.
Q. In the middle of the page you have "Drum SKUs no more expensive than Amber Leaf SKUs"?
A. Yes.
Q. While we are there we might as well also have a quick look above that, immediately above that, it says:
"Drum SKUs not more than 5p more expensive than Sterling, no more expensive than Dorchester."
A. Right.
Q. We will look at some documents about those brands too, but could you turn to tab 53, {D17/53}, please.
A. Do you want me to keep this tab open?
Q. You don't need to at the moment, no, we will come back there before very long. Do you want to just read that to yourself. Obviously start at the bottom.
(Pause)
A. Okay.
Q. So this is a situation where you want Drum to be at parity with Amber Leaf, you notice that Amber Leaf has reduced in price, and that means that, if you want to

achieve parity, you have to reduce the price of Drum too?
A. Yes.
Q. You say that you want a parity position and therefore you offer a tactical bonus?
A. Yes.
Q. To fund that, for want of a better way of putting it?
A. Yes.
Q. When you fund that level of price at 2.09, is it fair to say that you expect them to go to 2.09 rather than a lower price, assuming they take up the offer.
A. I would expect them to -- can you just say that again?
Q. Go to 2.09 rather than a lower price than 2.09?
A. I think that what I am suggesting here is that I am prepared to make an investment on this brand which means that if you want to maintain cash margin, you would be at 2.09.
Q. Well, I think what you actually say is "could you reduce the shelf price from 2.12 to 2.09"?
A. Yes.
Q. So I think what you actually do is ask them to reduce the shelf price --
A. Yes.
Q. -- rather than say "If you want to maintain your margin", that's because you want to match Amber Leaf,

isn't it?
A. Yes.
Q. But my question was on a slightly different point was: when you pay a bonus which maintains the margin at 2.09 but not a lower level than 2.09, would you expect them to go to 2.09 rather than a lower level than 2.09?
A. I would expect them to do that but it is not unheard of for adventurous buyers to declare their own independent thoughts on it, and sometimes prices would be lower than that. But you would expect that, because if they weren't to do that, they would reduce their cash margin. They might make a call and say "I am going to reduce it further, I am prepared to take less cash margin, he has given me some support, I'll put some more in as well", so that could happen.
Q. You weren't funding a better position than 2.09?
A. No. No.
Q. You don't say "Can you go to 2.09 or lower", you say "can you go to 2.09?"
A. I do say that.
Q. Is that because that's what you meant?
A. That's what I was suggesting I wanted, yes.
Q. Mr Batty, I think you said you have looked at some of his evidence?
A. Yes.

Q. But I won't expect you to remember all of it.
A. No.
Q. He said something along the lines of "Imperial would tend to be reactive in this sort of situation", they would react to what the competitors were doing, but the implication was that Imperial would tend to follow Gallaher in this sort of situation rather than vice versa. Would you agree with that?
A. To a point. I don't think, again, it's black or white. We could be reactive but I like to think that our market share over this period increased dramatically because we took the lead, and in fact we were more aggressive than they were, particularly on Richmond, where we made huge investments.
Q. So when you say "our market share increased", what are you talking about there?
A. Well, our market share during this period was on a growth path because we were --
Q. Sorry, what market share --
A. The cigarette market share.
Q. The whole cigarette market share.
A. Yes.
Q. So this is actually roll-your-own, isn't it?
A. You mean -- are you saying were we reactive in RYO? Were you being specific to RYO?

Q. I wasn't being specific, Mr Batty wasn't being specific.
A. Oh, I see.
Q. As I say, I just wanted to understand what your answer related to.
A. Okay.
Q. The bottom email focuses on 12.5 gram packs. If you look at the top email, this expands the discussion to all stock keeping units. What seems to have happened is you had a conversation with Paul Giles in which he asked you if you wanted to match Amber Leaf on all SKUs, not just 12.5, and you followed up with an email saying "Yes"?
A. That looks as exactly that happened, yes.
Q. This is an example of him proactively giving you an opportunity to respond on the other stock keeping units?
A. Yes.
Q. I think we can see again that you wanted to match Amber Leaf rather than wanting a price better than that?
A. Yes.
Q. Could we now just turn back to 17/4, which is the other trading agreement. This is a slightly more basic form of agreement. I think I can say that, because I don't think you wrote this one. Is it fair to say that your dealings with Morrisons in relation to P&Ds at the time of this agreement worked in essentially the same way --
THE CHAIRMAN: Mr Matthews, it's tab 4 of the bundle. {D17/4}
MR WILLIAMS: Sorry, I am speaking in code, am I?
A. No, my hearing isn't quite as good as it used to be, and I should have been listening better, my apologies.
Q. When I say 17 something, you can ignore the 17, because you have 17.
A. I am there now, I have it in front of me.
Q. This is the first trading agreement in the period we are looking at. It's slightly more basic, but you didn't write this one, so I can say that.
Your dealings with Morrisons, is it fair to say that your dealings with Morrisons in relation to parities and differentials at the time of this agreement worked in essentially the same way as the trading agreement we were just looking at?
A. I think that the aspirations would have been very similar.
Q. In terms of the agreement, I think one point we will come to in a minute is that the bonus is actually worked out in a different way here, it's an off-invoice bonus which you can see on page 4, but in terms of what happened day-to-day, did things work in broadly the same way under the two agreements?

A. Yeah.
Q. In this agreement, you will see the first sentence, and it says:
"Provided ITL prices are in line with our current strategy."
If you flip to appendix 2, which is actually page 5, and appendix 2 is rather unhelpfully bottom right, this is the ITL strategy pricing sheet, and this is all about differentials, isn't it?
A. Mm.
Q. So just going back to page 2, when it says "ITL agreed to maintain levels of off-invoice bonuses provided prices are in line with the current strategy", what you are paying them for is the differential strategy and this doesn't deal with absolute prices?
A. I can't agree with that, I am afraid, and at the risk of repeating what I said earlier, the off-invoice bonus per outer would have been paid in relation to recognising and rewarding Morrisons selling tobacco products cheaply, below RRP, bargain basement, as well as them rewarding us by reflecting those price list differentials, so all those bonuses on that page 4 from the top to the bottom would be in reflection of both those points.
DR SCOTT: Mr Matthews, just pausing on that point for

a moment, if Morrisons were pricing below the recommended retail prices but if they were favouring Gallaher's in relation to selling below recommended retail prices, what would have been the impact on ITL?
A. I think that that would have been not a good outcome, because whilst they continued to provide economically attractive brands or products, that we would have felt that we were disadvantaged on a comparative basis.
DR SCOTT: So that in making a trading agreement, you would have been concerned to ensure that ITL was not so disadvantaged?
A. That would certainly be our aspiration, but we did know that from time to time there was the danger of that happening.
DR SCOTT: Yes, and that's when you went into the negotiations on the tactical bonusing, as we heard?
A. Yes.
DR SCOTT: Thank you.
MR WILLIAMS: So I think what you said, although I might have misheard you, is that every bonus on page 2 is paid in respect of, I think, amongst other things, possibly, pricing below RRP; is that what you said?
A. I think that these bonuses are paid for, for two things --
Q. What do you mean by "these bonuses", sorry, that was the

first question I was asking you?
A. The ones, unless I am misreading it, page 4, for example Embassy No 1 Kingsize --
Q. Sorry, I understand what you are saying, I had page 2 open, and you said all of these bonuses from the top to the bottom of the page, and that includes --
A. I beg your pardon.
Q. No, that's my misunderstanding.
So you are saying that the off-invoice bonuses are paid in respect of --
A. Yes.
Q. -- matters including RRP. We had a discussion about RRP pricing in relation to the second trading agreement, but that was in the context of a provision which did actually at least talk about absolute price levels?
A. It did.
Q. This agreement doesn't talk about absolute price levels at all?
A. It doesn't.
Q. So I think all I am putting to you is that this agreement provides for you to pay an off-invoice bonus in relation to pricing for pricing in accordance with the differentials --
A. I -- sorry, were you going to continue there?
Q. I can stop there. That's the point. That's what the

agreement provides for?
A. I think that -- and again my apologies for repeating the point -- you said yourself that this agreement wasn't written perhaps as clearly as the one that I had written later on, and they were largely down to the personal idiom of the individual national account manager, and as I said before, they weren't supposed to be legally binding, didn't cover every eventuality, but largely were there to reflect the custom and practice of dealing with supermarkets, which was very much, in this case, an unwritten understanding that they would price their brands cheaply, we would understand that and reward them for doing so. But at the same time to, what we would expect from the quid pro quo is that we would have those differentials that we desired.
Q. I am not disagreeing with you about that, it's just the fact that this doesn't talk about absolute prices or RRP, and I am just saying really what it says on the page, which is that the off-invoice bonuses paid under this agreement didn't relate to below RRP pricing.
A. Again, my apologies if I am going off subject here, but if I look at the merchandising part of the agreement, it says "ITL products achieving position and space in line with market performance", that's a pretty broad spectrum. I think that, you know, these agreements

would have been 15 pages long if we had considered every eventuality. You are absolutely right, it doesn't mention it there, but that would be because of the person writing it and the implicit understanding that's what Morrisons did. They advertised on television "we sell products cheaply" and we would have expected them to continue doing that.
Q. I am just a bit confused because Morrisons sell prices cheaply just because that's what they do, in a sense you don't need to pay them to do that. I am just a bit confused about why you would include a bonus to pay them to do something that you had absolute confidence they were going to do anyway?
A. I am not sure we had that complete confidence and, you know, maybe you are right, maybe we shouldn't have paid all this money, but it was a case of paying it because of custom and practice and the expectations of the supermarkets. They very much felt, and perhaps it's wrong of me to talk on their behalf, this was the cost of doing business with Morrison. We are the retailers, we know the right prices, you pay us the money and we will look after you. This is how supermarkets do sell their products cheaply, because they have suppliers who are investors that help them do it, and without the support of big suppliers liked Imperial Tobacco, they

wouldn't have been able to maintain their market position across most of their products.
Q. I think when we were talking about TA2, the second trading agreement, you said that you paid or offered them a bonus because it was your aspiration that they would price in accordance with your strategy?
A. Yes.
Q. I think a moment ago you have just used the expression "the cost of doing business with Morrisons"?
A. That's what Morrisons would have thought.
Q. But from your point of view the bonus was paid for achievement of your strategy?
A. No. My apologies for repeating it again, but I paid bonuses based on two quite clear criteria, the fact that they were prepared to stump up cash and reduce marked pack or sell products at lower margins and that my investment was based on that and that I would also get my price list differentials.
Q. I don't think we are disagreeing, Mr Matthews, I just said that from your point of view you paid them bonuses because you wanted them to achieve your strategy, now that strategy might have different strands, but from your point of view, this wasn't the cost of doing business with Morrisons, this was a bonus paid for a purpose?

A. No, it was the cost of doing business with Morrisons, because if I had taken the money away I would have had a very difficult trading relationship, like all relationships with big companies.
Q. Moving down this agreement, further down we see that Morrisons is to tell you if there is a promotional activity which affects differentials?
A. Yes.
Q. It goes on to say:
"Should ITL agree to maintain bonus levels in line with appendix 1, should we elect not to respond to other manufacturers' pricing initiatives", so that's what this is about, it's about other manufacturers' pricing initiatives?
A. That's one possibility, yes.
Q. That's what this is about, though?
A. When you say this is what this is about, sorry, I am losing the thread --
Q. The paragraph that starts:
"WM Morrison to confirm instore promotional activities", up to the words at the end " ... other manufacturers' pricing initiatives".
A. Right.
Q. I was just putting to you that that paragraph seemed to be about promotional activities that were the result of

other manufacturers' pricing initiatives?
A. Yes, that would be the right to respond, I think you called it earlier.
Q. If we could turn to page 5, we see that some of the requirements are expressed simply in terms of parity and others are in terms of "not more than" or "at least", I am not going to have a debate with you about that, but I am just noting it while we are here. While we are here, just to pick up, there are differentials between Embassy and -- sorry, different permutations of Embassy and B&H, and that's a minus 3 on a pack of 20, and Regal B&H, minus 5 on a pack of 20?
A. Yes.
Q. We also see further down Cafe Creme, Small Classic, are linked to Hamlet Miniatures. I am just noting these because we will go to some documents in due course.
A. Okay.
Q. Can we go to tab 85, {D17/85}, and back to the second page with the heading "Pricing". Just focusing really on the first bit of the first paragraph under "Pricing":
"Morrisons agree to continue supporting Imperial Tobacco's pricing strategy."
We have seen that that includes the differentials. It goes on underneath in the next paragraph:
"Based on continued achievement of those

differentials as well as the shelf prices in the schedule."
Then top right, on the next page -- sorry, is your bundle top right? It's page 464.
A. Yes.
Q. "At the time of writing, the following price list differentials should be reflected in Morrison's shelf prices."
A. Yes.
Q. So the agreement records that first of all Morrisons it had been supporting your pricing strategy, as in the words "continue supporting", so they had been supporting your pricing strategy?
A. I hope I don't sound as though I am being obtuse, I promise I don't mean to be obtuse, but sometimes the commercial language of these agreements is a little bit flowery. So when you say "The continued support", you know, that doesn't mean that there is a sort of cast-iron guarantee, it means that generally speaking Morrisons have been supportive of Imperial, and generally speaking Imperial Tobacco has been supportive of Morrisons, it doesn't mean that there wasn't a fairly testy commercial relationship between the two. I just wanted to make that point.
Q. You have made that point now. As I say, the idea here

is that there has been achievement of the differentials, and they are now agreeing to continue to support the strategy of pricing in accordance with the differentials. That's just what this says?
A. It's what it says, and that's the aspiration and the intention, and Morrisons might or might not have seen it differently. Again, my apologies for drawing this out, but these agreements were the basis for negotiation very often.
Q. I thought it was the outcome of a negotiation?
A. Ah, well, a negotiation is something that is -- doesn't end, it keeps going and going and going, and the signing of this agreement -- and it covers much more than pricing, in fact you could argue some of the other issues are far more important -- but this was a point in time, and there was far more negotiation between the two agreements than there was negotiating agreement to be signed.
Q. We can ask Morrisons what their perspective on all of this was, but from your point of view you had secured their agreement to support your differential pricing strategy?
A. I felt that I had gained their confidence to understand what I wanted and, within a commercial relationship, subject to an immense amount of fluctuation and change

I could achieve it, but it wouldn't be based just on this agreement.
Q. I am not exactly sure whether that answered the question or not. I think all I was putting to you is that what this records is that you thought you had secured their agreement to your strategy?
A. Except that there were very specific references for when -- or remedies for when that was out of line, and there would be lots of them, hence my wording on the pricing piece.
Q. Language like "the following price list differentials should be reflected in Morrison's shelf prices", you basically had formed an expectation this agreement gave you the basis for an expectation that they would price in accordance with the differentials?
A. An expectation.
Q. Would you agree with language like "continued achievement of those differentials" that Morrisons got the differentials consistently right?
A. They didn't.
Q. Could we turn to tab 96, please. {D17/96}. This is a national accounts customer plan. It's at tab 96 because the date is slightly unknown, I think, but I think we can put it at the back end of 2002, possibly in advance of the beginning of 2003. Does that look

about right?
A. Yeah, I would say so.
Q. Could we turn over the page, there is a lot of material in this document that is in theory confidential, I am not sure if it really is confidential. It would be very helpful to be able to talk openly about what's said. The paragraph I am interested in is on page 225. You will appreciate these page numbers aren't logical, but I'll use them anyway. The paragraph that starts, "However, as testimony ..." which is I think four paragraphs down, could you read that?
A. Do you want me to read it out loud?
Q. No, I don't.

(Pause)

In terms of, I can't actually work out what's confidential and what's not on my copy, because it's quite confusing, but I think the words that aren't confidential are "pricing differentials consistently right", and I don't think the words after that are confidential, are they? Does ITL have a view about that? No.
THE CHAIRMAN: You don't have a view or they are not confidential?
MR HOWARD: I don't have a view and I don't think they are confidential.

MR WILLIAMS: In that order.

Both quick to respond and co-operative. So this is an internal ITL document, isn't it?
A. Yes.
Q. This is not a document where you are massaging Morrisons' ego. Am I right in thinking that what this is recording is that the differentials we have just been looking at in the trading agreements were consistently right?
A. It might not have been massaging Morrisons' ego but it is an internal document, sometimes one speaks bravely in internal documents. I am not sure which is sensitive or not, but it does include quite a few other areas I think --
Q. We will come to those others, if that helps, but "focusing on pricing differentials consistently right", was that an accurate reflection of the position on the account that you were relaying to your superiors or was it not accurate?
A. I am not sure how you would measure accuracy in this instance. I would say that largely Morrison wanted to work with us, but like all buyers and like all supermarkets, they had their difficulties. I mean, it wasn't an easy relationship from time to time.
Q. But at the time you were dealing with Morrisons, you

took the view that they were basically implementing your differentials?
A. I felt that more often than not, I could negotiate a settlement with them.
DR SCOTT: Just to get the picture of Morrisons just briefly, you were sending out multiple trade representatives visiting the stores?
A. Yes.
DR SCOTT: Were their stores pretty disciplined about following Morrisons' pricing or were they indisciplined?
A. There were far fewer Morrisons than other supermarkets so they generally got things right and they were regional, so again they had less management tiers but there were notable exceptions down to poor store discipline, but they were quite good.
DR SCOTT: Thank you.
MR WILLIAMS: Can you keep that page open and go back to paragraph 113 of your witness statement.
A. Yes.
Q. Just read that to yourself. Can ITL's legal representatives tell me whether what's said to be confidential in here is really confidential?
MR HOWARD: Sorry, which bit?
MR WILLIAMS: In 113 of Mr Matthews' statement.
(Pause)

MR HOWARD: We waive any confidentiality.
MR WILLIAMS: I am grateful.
(Pause)
So this talks about problems making sure that new products were adopted, and if we just go back to 17/96, {D17/96} in the paragraph we were looking at it says:

Confidential ITL

[redacted]

That's new product development, is it?
A. Yes.
Q. So am I right in thinking that what you are saying there is that Morrisons were good when it came to listing and not only were they good in terms of coverage, they were actually quick to respond as well?
A. On listing products, are you asking me?
Q. That is what I am asking you, yes.
A. Yeah, they were, they got better, definitely.
Q. So when you say in your statement "it was a constant struggle" --
A. Yes.
Q. -- "to make sure that new products were adopted", is that not quite right?
A. I may be reading the wrong document. It says here: "It was a constant struggle in the account to make

sure our products were prominently displayed ..."
Q. "... and that new products were adopted."
A. Sorry, can you just repeat the question again?
Q. The question was really just based on what we see in the document at 96 which says:

Confidential ITL

[redacted]

Whereas the witness statement says it was a constant struggle to make sure that new products were adopted?
A. Right.
Q. Do you think the witness statement puts it a bit high? Because what 17/96 tells us is that they were quick to respond to NPD, new product development, and that there were few gaps in listing?
A. I mean, I can't remember the context of when this internal document was written, I can recall that having inherited the account in 2000, that after that it did become easier to get new products on the shelf. Definitely.
Q. So at the very least the word "constant" is not quite right?
A. "Constant" might not be completely right, as I said it was an internal document and sometimes you become brave by talking brave.
Q. I am just going to ask you to read something else now, it's paragraph 47 of the statement. There's a reason

for asking you to read this given the way in which you hesitated over paragraph 113.
A. Witness statement 47?
Q. Paragraph 47, that's right.
A. Okay.
Q. Apart from the words "Sainsbury" and "Morrison" those paragraphs are absolutely identical, and I wanted to ask you: is it the case that your relationships with Sainsbury's and Morrisons were identical, or has just something gone wrong in the drafting here?
A. I think that every account was very different and I would say I thought I had good trading relationships but I would say that there was definitely a difference in all the supermarkets because of the styles of the people you dealt with.
Q. I can fully understand that, the reason for asking you the question is just that paragraphs 47 and 113 are identical, so really going back to 113 --
A. Yes.
Q. -- does this accurately describe your relationship with Morrisons or is it cut and pasted from Sainsbury's or vice versa?
A. I think they are both reflective, I mean Morrison and Sainsbury had some similarities, they were broadly positive commercial relationships with both.

Q. Broadly positive as opposed to constant struggle?
A. Well, that's just one part of the relationship.
Q. But it is the part that you have chosen to describe in setting up your relationship with Morrisons in the first paragraph of this section of your witness statement.
A. But the internal document talks about more than just listing products.
Q. I agree with that, it's just that your witness statement talks about listing products.
A. Right. Yeah, there is a disparity in that internal document and what is said there.
Q. I think you also talk in this paragraph about "constant struggle in relation to the obtaining of space on the shelves". Could you turn over to 229.
A. Yes.
Q. You see, about the middle of the page, it says "Specific account strategy"?
A. Yes.
Q. Could you read the two paragraphs of point 1, please.
(Pause)
A. Yes.
Q. At this stage, you seem to think you have reached agreement with Morrison on significantly increased share of space on the planogram; is that right?
A. That's the account strategy and I felt I was close to

that.
Q. So you have increased your share of space significantly from -- well, from one number to another number, I don't think we need to worry about reading out those percentages.
A. Okay.
Q. So it seems that any struggle you had in relation to display yielded fruit in a better outcome for ITL there?
A. That looks as though I definitely was breaking through there, yes.
Q. If you go back up the page, right in the middle of the page, it says "our relationship with the buyer"?
A. Yes.
Q. It's a short sentence. So the buyer there is Mr Giles?
A. Yes.
Q. And the manager is Mr Eastwood?
A. Yes.
Q. And your relationship is sound and has greater continuity than relationships with other manufacturers?
A. I thought so, yes. I mean, again difficult to measure. Morrison had quite a few different people in the role, and with this particular gentleman it was a positive relationship.
Q. So would you agree that paragraph 113 of your statement paints an unnecessarily gloomy picture of the

relationship you had with Morrisons?
A. I think -- I am not sure about gloomy. Perhaps it's a bit more realistic than the internal document. I mean, they are both different context.
Q. While we are jumping around your witness statement, could you go back to paragraphs 10 and 11 and just read those to yourself.
(Pause)
A. I am lost again here, I am terribly sorry.
Q. In your witness statement, page 552 is the bottom right.
THE CHAIRMAN: Tab 42.
MR WILLIAMS: Sorry, I thought you had your witness statement open, I beg your pardon.
A. No. And 11?
Q. 10 and 11 please, yes.
(Pause)
A. Okay.
Q. I am sorry to do this, but could you turn back in that witness statement file to tab 33, and go to paragraphs 3.1 and 3.3 of Mr Batty's witness statement, which you will find at tab 33, and just read those to yourself.
A. I am terribly sorry, I got my 10 and 11 --
Q. I am sorry, we have been jumping around in these files for weeks now and we know what we're doing. It's tab 33

in the witness statement file.
A. Okay.
Q. Internal page 329.
A. Yes.
Q. Just read paragraphs 3.1 and 3.3. There is obviously 3.2 in the middle but I think you will be able to make sense of it.
A. Right. Okay.
Q. Do you want to read 3.1 and 3.3 of Mr Batty's statement?
A. Yes, I am reading it. (Pause).
Q. So I think apart from a few drafting changes, the odd word here and there, these paragraphs are identical to paragraphs 10 and 11 of your witness statement. I just wanted to ask you who drafted these paragraphs?
A. Which, the Roger Batty?
Q. Well, no, I can't ask you who drafted Roger Batty's statement, but paragraphs 10 and 11 of your statement.
A. Well, this would have been done in conjunction with our legal team.
MR WILLIAMS: I don't know if that's a convenient moment, madam.
THE CHAIRMAN: Yes, thank you. We are now going to take a lunch break, Mr Matthews. Now, because you are in the middle of giving your evidence, that means you mustn't talk to anybody about the case over the lunch

adjournment, so I am afraid you will have to be antisocial with the rest of your team because your evidence mustn't be discussed with anybody else.
A. I understand.
THE CHAIRMAN: Thank you. We will come back at 2 o'clock.
(1.05 pm)
(The short adjournment)
(2.00 pm)
THE CHAIRMAN: Yes, Mr Williams.
MR WILLIAMS: Good afternoon, Mr Matthews.
A. Good afternoon.
Q. Before lunch we were looking at, amongst other things, the trading agreement. You don't need to turn it up now but we looked at the provisions which said that Morrisons agreed to support your pricing strategy in return for payment of bonuses, and the agreement also said that prices should be in line with the differentials.
Having signed Morrisons up to that agreement, I don't suppose you thought that Morrisons were free to disregard the differentials if they wanted to?
A. No. I think that wasn't the intent, but we did also recognise that as part of the weave and weft of a commercial relationship that there would be times when they could put pressure on that, hence our need to from

time to time increase our investments.
Q. So from your point of view you thought the agreement put a constraint on how Morrisons was going to price its products?
A. I felt it was a good basis for negotiation on a whole range of things.
Q. I think as we explored before lunch obviously there would be negotiations after that, but it was also the outcome of a negotiation, it was agreement?
A. Of one part of a negotiation, yes.
Q. So having decided to invest in their business under that agreement, you expected Morrisons to price in accordance with the agreement?
A. That was certainly what we hoped for, yes.
Q. Could we look at document 59 in the Morrisons file, please. So this is an email. Do you want to read it through?
A. If I could have a couple of minutes.
Q. Of course, yes.
(Pause)
A. Okay.
Q. So basically you want to align Drum and Amber Leaf, Amber Leaf has come down, and so you offer a tactical bonus and say that you want them to bring Drum into alignment with Amber Leaf?

A. Yeah, I mean, I think this is quite a good example of what you were alluding to before that, having signed an agreement, we had aspirations for pricing positions, but clearly within the period of the agreement this would be a very good example of where we had to operate outside the confines of that to do exactly as you say.
Q. Is this outside the agreement, though? Because they have reduced the price of Amber Leaf and you are responding.
A. But the agreement, as we were talking earlier, contained both ongoing and tactical bonuses.
Q. Yes.
A. And under this scenario, we would want to make more investment than we had suggested in the initial agreement.
Q. Yes, so I rather saw this as an example of you applying the opportunity to respond clause?
A. Yes, but it's part of the fluidity of our investment.
Q. What you say is you want prices to be aligned, you don't say aligned or better, so really you were looking for the same price rather than a better price?
A. Yes, I wanted to limit my investment and remain competitive against a comparable brand.
Q. There is a similar exchange a bit further down in relation to Hamlet Miniatures and Cafe Creme?

A. Yes.
Q. If we turn over to tab 60, you can see there is two pages here, the second page is the same email or some of the same email. If you go back to the first page, at the bottom it says:
"Prices are keyed down, I await new schedule"?
A. That's on 59. Which was the one that you --
Q. Are we at tab 60? You can see at the second page of tab 60 it's the same email?
A. I beg your pardon, yes.
Q. Back on the first page of tab 60, it says "Prices are keyed down" --
A. Yes. I understand.
Q. -- so Morrisons agreed to do that for you.
Can we now turn back to tab 2, please. You can tell me whether you have seen this document before. It's a Morrisons supplier meeting notes. I think it pre-dates your involvement with Morrisons?
A. It does.
Q. Do tell me if you don't want to answer questions about it.
A. I'll do my best.
Q. Did you have meetings with Morrisons where they sort of filled in forms like this?
A. From time to time but they were an informal organisation

and I can't remember many of these.
Q. You can see this is a meeting, Colin Wragg and Justin Addison attended. This is a previous generation of the relationship. Down at point 3 it says:
"Justin Addison to realign HR [I believe that's handrolling tobacco] retails. Action: JA."
A. Yeah.
Q. So you may not feel able to comment on this because obviously you weren't at the meeting, but my reading of that is that this is an arising from the meeting, so Imperial have probably raised at the meeting the need to realign hand rolling tobacco retails and that's an action that Morrisons had taken away something they are going to do. That would be my reading of the document.
A. It would be mine too, although realign, I mean, it's obviously shorthand, which I suppose is testimony to their informality. I can't comment on how that, what it exactly meant.
Q. Thank you. Could you now look at something slightly different, which is Mr Eastwood's witness statement.
A. Right.
Q. You know who Mr Eastwood is?
A. I do.
Q. It's in file 8, is it? Core bundle 8. I think it might

be at the back of this file, tab 94. {C8/85/436}
A. Mine only goes up to 85.
Q. Maybe you have the wrong file. It's file 8 rather than 7 I think we want.
A. Ah, that would be 7.
Q. Could you read paragraph 15 of that, which is on internal page 436.
A. Paragraph?
Q. Paragraph 15 on page 436.
(Pause)
So the point I take from that is that Mr Eastwood considered that entering into the agreements with ITL to be in Morrison's commercial interests?
A. Yes.
Q. I am sorry for showing you a series of slightly random documents, because I wanted to then just turn back to something you say in your witness statement at paragraph 129.
THE CHAIRMAN: Can we put Mr Eastwood away for the moment?
MR WILLIAMS: We can put Mr Eastwood away, yes.
I think the bit I wanted to focus on first is it is absurd of the OFT to suggest that a FTSE 100 company would meekly be told what to do with their prices by ITL.
Really what I wanted to put to you is that these

comments are attacking a bit of a straw man really, because the OFT's case isn't that ITL told Morrisons what to do, it's that Morrisons chose to enter into an agreement with ITL to support its strategy in return for bonus payments, and that's what happened, that's what we have seen, isn't it?
A. You are going to have to break that down for me.
Q. The thrust of this paragraph is a criticism of the OFT, saying that the OFT's case is based on ITL bossing Morrisons around telling them what to do, and I am saying that's not really what the OFT's found, the OFT has found that there was an agreement or an understanding between Morrisons and ITL that Morrisons would support your strategy and that you would pay them bonuses to do so. We have seen the agreement and I've just shown you a couple of documents where it appears that Morrisons were happy to do that. So the point I am putting to you is that the comment in 129 is not really engaging with the case that your evidence is concerned with?
A. I am probably confusing -- I mean, I stand by the fact that it is absurd to suggest that a large retailer would do what they were told by Imperial Tobacco, I think I feel that quite strongly, but I am not sure the relationship between what I've said there or what's

written there and what you are suggesting, I am sorry, I am a bit slow, I am just not really picking up on that.
Q. Putting it shortly, Mr Eastwood has just said that he regarded the trading agreement as in Morrison's commercial interests; you saw that, I showed you that?
A. Yes.
Q. So I am just saying that your comment is not really dealing with the case. The case is that there was an agreement or understanding which Morrisons entered into for its own reasons and under which it was going to be paid bonuses and in return for which it would do certain things for ITL?
A. Yeah, I think that's fair enough, it was an agreement that did just that.
Q. I think you say that Morrisons was at all times free to decide its own retail prices, but I think you have already agreed that the purpose of the agreement from your point of view was to constrain their freedom so that they would price on the basis of your strategy?
A. I can't agree that I agreed with that.
Q. We will have a look at the transcript in due course. Could you go into file 17 again, please, and turn to document 23. {D17/23/193}.
MR HOWARD: I would have thought, rather than having

a debate about the transcript, surely if there is a point which is sought to be put, a challenge to the witness, it ought to be put fair and square so he understands what it is. It's not a question of trying to see whether you have got him to say yes to something where he is saying he doesn't understand he said yes to that. In fact, the question was, I think: was there a constraint? The constraint hasn't been identified, that remains the case throughout. If it admit to be said that this witness is agreeing there was a particular constraint on Morrisons, one really ought to identify what the constraint was.

THE CHAIRMAN: Well, I think the question was being put to him that he had said in his witness statement that, even though they had signed the agreement, Morrisons remained entirely free to price as they saw fit. The question I understood was being asked of Mr Matthews -- perhaps I can ask it -- is: do you agree that, in signing up to the agreement or in entering into this agreement, the parties expected or hoped or intended that it would influence Morrisons as regards the setting of their retail prices?

A. No.

THE CHAIRMAN: Well, what were you paying them the money for, then?

A. We were paying them to reflect the fact they sold prices at lower than RRP and from time to time we invested money to react and respond to moves in the market. Now, that might, from time to time, as we have seen in some of these documents, be a request for Morrison to respond to something and the output was that there was a price we were hoping to achieve. Hopefully I am not treading on the wrong territory, that seems different to me than telling them what prices to sell at, generally speaking.

THE CHAIRMAN: We are not talking about telling them what prices to sell at, we are focusing on the differentials between the Imperial products and the Gallaher products, whether by attaching that schedule that we have seen of the "not more than 3p or not more than 5p" and offering them ongoing bonuses, part of which was supposed to reflect their agreement to do that, whether you then expected them to do that, subject to these times when manufacturer intervention caused things to go out of kilter?

A. Yes.

THE CHAIRMAN: Right.

MR WILLIAMS: Do you have document 23 there?

A. I do.

Q. What I am going to do now is start to look at what was the strategy that Morrisons had agreed to support. Just

looking, first of all, at page 193, a slight detour: do you see there is a heading "Morrisons and Tobacco"?

A. Yes.

Q. Underneath the first paragraph there is a single line paragraph?

A. Yes.

Q. So Morrison's strategy was clear to you in relation to tobacco?

A. Yes.

Q. At page 200 of this document, {D17/23/200}, if you just turn over, and obviously I should have said but we all understand this is a document you drafted, I think, isn't it?

A. It is a document I drafted, yes.

Q. We see at 200 you start to deal with your strategy for the financial year.

A. Right.

Q. So it's an obvious point, when you were designing this strategy, you had in mind Morrison's strategy?

A. Yes.

Q. The two were designed to work together as best they could?

A. Yes.

Q. If you look at the first point, there are two introductory paragraphs which end with a colon?

A. Yes.

Q. You have read those, have you?

A. Yes.

Q. Then seventh paragraph down, it may be the paragraph between two boxes on your copy, I don't know if it is?

A. Yes.

Q. There is a description of what your pricing strategy was in recommendation to pricing differentials?

A. Yes.

Q. It says:

"The strategy is to reflect current list price differentials."

And "reflect" here as in the shelf prices?

A. Yes.

Q. So the way this works is you have the RRP for an ITL brand?

A. Yes.

Q. You have the RRP for a Gallaher brand, you identify them as a pair, and you work out the difference between them, and that gives you a number, let's say it's 3p?

A. Yes.

Q. Your strategy is that shelf prices should reflect that 3p differential?

A. Yes, or better.

Q. Well, you say that, but that's not how the strategy is described here. It says you should reflect the differential, and the differential is not a maximum or a minimum number, it's just a differential?

A. But it would be better, wouldn't it, if it was better than that differential? So, for example, if we had an aspiration that Richmond and Mayfair should be the same price, if we were cheaper, I mean, that would be a good thing, and any opportunity that we could -- to try and, even for a limited time, achieve that, would be a good thing. That would be better, much better.

Q. Could you turn to tab 16, please. Do you want to read that to yourself?

A. This is Richmond Kingsize and Superkings.

Q. Sorry, it's 15 November 2000, that's right, yes.

A. Okay. (Pause). Okay.

Q. So, first of all, just looking at the language of this document where you say "We are moving" -- sorry, do you have that, "in the light of this we are moving Richmond Kingsize up to 224/225"?

And then right at the bottom:

"Please let me know when you can move your shelf prices."

So this is an instance where you did expect Morrisons to price at 3.34 when you removed the bonus?

A. Well, that's their call. I think what I am trying to

highlight here, I am afraid that some of these documents are rather turgid because they were largely -- in many ways they were part of an audit trail, and I am going off-piste here a little bit, but the sums of money involved were very often [redacted], particularly in the larger supermarkets and I was relatively young at the time, I always felt I should keep very clear records of what was being paid for what, and this document shows to Morrison the natural commercial outcome of that move. Morrison could argue with it, they could say "I want to keep it on the shelf for longer", they could say "I want to keep the price down, would you support some of it?" They could do what they wanted. This is a record of the commercial outcome of what would happen if they chose to follow this strategy.

Q. I think what you have done there is really repeat an account of these sorts of documents you give in your witness statement, but it didn't really answer the question I asked you which was about something a bit different, which was, just looking at the language "we are moving" and "please let me know when", I was just saying it does look as though this is a good example of you assuming that when you take the bonus away, they will move to 3.34?

A. Well, I think that assumption would be based on the fact that if they weren't to do that, it would have a suboptimal impact on their margin, particularly their cash margin, and I am just laying that out as plainly as I can in this communication.

Q. This document tells us that when you say you have a strategy of parity, that doesn't mean no more expensive than, because Richmond was no more expensive than Dorchester, and yet you were asking Morrisons to increase the price?

A. Right, asking them, yes.

Q. Do you agree with that?

A. I am suggesting that, yeah.

Q. But you are asking them to increase the price?

A. I'm saying in order to maintain your cash margin the bonus level should be as follows, so I suppose implicit in that, if they didn't want to maintain their cash margin, they would make a different call.

Q. Can we look at the order of the points in this document, because you are talking about the bonus and the cash margin, but actually really where this starts is the paragraph:

"You are probably aware that the broad marketplace has moved from 3.39, 3.40 to 3.34, 3.35 on Dorchester Kingsize and Dorchester Superkings. You may remember

from my presentation on the Richmond repositioning and the launch of Richmond Superkings that our strategy is parity with Dorchester."

A. Yes.

Q. "In light of this".

So do you agree that the "in light of this" is that the strategy is parity with Dorchester?

A. That's certainly our strategy, yes.

Q. And it is in light of the strategy that you are "moving Richmond Kingsize and Superkings up to 3.34, 3.35"?

A. Right.

Q. Do you agree with that?

A. I do.

Q. So that tells us that you wanted to see the price of 3.34, 3.35 because of your strategy of parity?

A. I hope I don't sound argumentative, and perhaps it's a urbane point or an arcane point -- and I know I am repeating myself -- but this is setting out the maths of the situation. I want to reduce my investment, my brand I have been investing in heavily, and when I do so, this is what would happen if you increased the shelf price. But that is all it does. My strategy might not be the same as Morrison's, and Morrison might, for example -- and I do not want to bring other accounts but other grocers might not want to follow this, and they might

not have wanted to follow this.
Q. I am focus at the moment on what your strategy was, what you were seeking to achieve.
A. Yes.
Q. I think the point I am putting to you is that, just reading the word on the page --
A. Yes.
THE CHAIRMAN: There is perhaps a prior point. Where it says "We are moving Richmond Kingsize and Richmond Superkings", was that we, Imperial?
A. I think it's probably we, me, and what I probably ought to have said is that I would like to do this.
THE CHAIRMAN: Right. It's not "we", you and I?
A. No, I understand the point now.
THE CHAIRMAN: Not "we", Mr Addison.
A. I can't -- I suspect that it's not you and I, it's more we --
THE CHAIRMAN: The royal "we"?
A. Exactly, I think it's Imperial want to reduce our investment and want to move up.
MR WILLIAMS: I read it in that way because you say "our" strategy just before and the "our" is plainly Imperial.
So where had we got to? I think I was putting to you that the "we are moving", just as the Chairman identified, is talking about Imperial wants to see, it

wants to see a price of 3.34, and then what the document goes on to do is set out what is the bonus associated with the shelf price of 3.34?
A. In order to maintain the cash margin. Now, by saying that, in order to maintain your cash margin, yes, you are absolutely right, we have been investing heavily in Richmond, we saw an opportunity to take the foot off the gas, in other words reduce our investment in that brand, and I am saying to Justin in this instance "there is a movement in the market, you have told me, we have had a phone conversation about it, I would like to reduce my investment. If I do that, and you move to 3.34, this is going to be your cash margin", so if they want to maintain their cash margin, this is what the commercial equation looks like.
Q. That's a letter you could have written, obviously, isn't it? You could have written a letter saying: Dorchester was being promoted, it's not being promoted any more, we have been funding a lower shelf price, we obviously don't want to fund a lower shelf price if the rival product has gone up, as a result of which we are not paying a bonus any more. If you want to maintain your margin you can move it up to 3.34 but just to let you know we are not paying the bonus any more at 3.29 levels, that is just a different letter?

A. I suspect that happened and that conversation was part of the telephone conversation that I referred to.
Q. The impression I got was that this letter was a reflection of the telephone conversation rather than the two were in different terms?
A. In its perfunctory form, yes, but part of the conversation, and of course life as a national account manager is very much based on the telephone, I did try and keep these letters as short and sweet as possible, but preceding the letter, there would have been quite a long conversation about this, depending on how bellicose the buyer felt at the time.
Q. I don't think the letter I suggested would have been any longer, it just would have been different?
A. It might well have been different.
Q. On a different note, you have discussed this, as you said a minute ago, with Morrisons, and you then write to them, so it looks as though this letter is confirming what's been discussed and there was no particular difficulty about this?
A. It certainly confirms what was being discussed, whether or not there was difficulty in it I can't remember because these weren't, they weren't straight lines, a good buyer would not have accepted this, a good buyer would have argued for a very long time about this.

Q. We know that they did move the price to 3.34, we get that from 17/19, I don't think we need to turn it up, I am just giving that for the Tribunal's reference.
Could you look at a document in annex 18, please, which we haven't got at the moment. It's the Sainsbury's annex. It's at tab 22. {D18/22}.
A. That's a document about Sainsbury.
Q. It will be about Sainsbury, yes. It is tab 22. This is more or less the same letter as sent to Sainsbury's on, I think, the same date. The only reason for going to it is because there is one slight difference from the letter you wrote to Morrisons. Do you see in the second paragraph, it says:
"In light of this and not to hold the market up ..."
Do you see those words?
A. I'm looking for them.
Q. The second paragraph "You may remember"?
A. All right. (Pause). Yes.
Q. You say "not to hold the market up". So as I read it, that's saying that you don't want to deter retail price increases across the market, ie by you and Gallaher and that's why or partly why you are raising prices?
A. I think that's part of the language that you use with buyers. I doubt if she would have been moved by that, but it was to try and put some impetus behind the fact

that I wanted to claw some of my investment back because at the time we were dangerously close to being underwater on that brand.
THE CHAIRMAN: Could you just explain again what is meant by "and not to hold the market up and not to delay the upward movement in the price"?
A. "Let's get the price up, Fiona, you can take more cash in the till, I can recoup some of my investment, it seems to be happening, why wait".
THE CHAIRMAN: How would they make more cash in the till?
A. Well, they would take more cash. It was, to be quite frank, a spurious argument, whether 5p or 6p on a packet of cigarettes would have a massive effect, but it was one I tried to use that they wanted to take as much turnover through the till as possible, so by putting the price up you get some inflation and some additional turnover.
MR WILLIAMS: Could you turn to paragraph 56 of your witness statement there, please, which deals with this letter. It's quite a long description, and you deal with some of the issues that you have covered already in your evidence in relation to Morrisons. On page 20 --
A. 56 in the witness statement?
Q. Paragraph 56. That paragraph spans two pages.
A. I have the wrong 56 then.

Q. Sorry, it's your witness statement. I am so sorry.
A. No, no, it's me, I am not up to speed with these files as much as --
Q. So you are at tab 42.
A. Right, okay.
Q. You might still have been in Mr Batty's statement.
A. I was in somebody else's business there. What number is it?
Q. It's paragraph 56, page 20. Paragraph 56 runs onto a second page.
You can read the whole paragraph if it's helpful, but it really says some of the same things you said about the Morrisons document. The bit I wanted to focus on was, do you see at the top of page 20, about three lines down:
"I also say that I do not want to hold the market up."
A. I hope I am on the right page. This is 56?
Q. The top of page 20?
THE CHAIRMAN: Paragraph 56.
MR WILLIAMS: It says:
"... would have been the case if our bonus had continued."
A. Yes.
Q. Then three lines down "I also say"; do you see that?

A. Right. Yes, I do see it.
Q. This is said to be confidential, but I don't know whether it really is or not. No? So you say:
"This was not actually true, but I was trying to persuade Sainsbury to accept the ending of the bonus which was being withdrawn across the market generally."
I don't think that's exactly what you said a few moments ago, is it?
A. I don't think it's dissimilar. [redacted]
Confidential ITL
Q. When you say:
"I was trying to persuade Sainsbury to accept the ending of the bonus", I am not sure I understand that, because you say in paragraph 18 of your statement that decisions about the level of promotional funding were made by the ITL management team. Do you want to look at that? It's a fairly straightforward point. It's exactly what you would expect, ITL offers bonuses and it decides whether to withdraw them?
A. I think there was a little bit more play in it than that, largely because the relationships with these senior accounts wasn't one in which anything was black and white, and from time to time you could get additional investment and hang on to investment longer, but in this particular case with Sainsbury and with --

I mean, I've also said there, mentioned or referenced Tesco, you know, if you were trying to money back on a brand, in other words hand reduce investment on it, you would pretty much try your hardest to do that, and sometimes, you know, there would be times in a relationship [redacted]
Confidential ITL
Q. All I am really saying to you is that you offered them a bonus and you could take it away; there was nothing to persuade them about?
A. I am not sure that -- I think that's too black and white. I mean, it's not as simple as that. If it was as simple as that it would have been done by computer. There was persuasion required, and there was negotiation involved.
Q. Persuasion required for you to withdraw a bonus?
A. Yeah.
Q. Have you still got annex 18 open?
A. I think so.
Q. While we have it open, could you turn to tab 20, please, and just read it to yourself. {D18/20}. I am not going to ask you any questions about it, I am just asking you to read it because it provides some useful background to a Morrisons document we are about to look at. You only

need to read down to the word "concept".

(Pause)

A. Okay.

Q. Just so that we pull out the point, this is an email on 26 September, Mayfair is moving up from 3.44 to 3.49 on 2 October, and you basically say you are going to change the level of the bonus which will give rise to a shelf price of 3.65 which brings L&B and JPS into line with a 16p price list differential?

A. Yeah.

Q. I am only showing you that because that document spells out a bit more background than the document in the Morrisons file that we are about to look at. Could you turn to document 9 in the Morrisons file, please, 17. You can put Sainsbury's away now, actually, I don't think we need that again.

A. Which document was it?

Q. It's number 9 in the Morrisons file. Do you want to read the section with "The pricing movements L&B JPS brands"?

A. Yes. (Pause). Okay.

MR WILLIAMS: Do you have it, Madam, sorry?

(Pause)

This is the same date as the email we saw in the Sainsbury file and it covers basically the same ground

in Morrisons but it just explains in a little bit more -- sorry, the Sainsbury's document explains what's happening behind the scenes, and this relates to the end of a period during which you paid retro bonuses on L&B and JPS to maintain a lower price against Mayfair.

Now, do you have your witness statement there? You deal with this in your witness statement at 142 and 143. It's 143 I was really interested in at the moment.

(Pause)

A. Okay.

Q. One of the things you say in this paragraph is that Gallaher was having an MPI on 2 October, and I think on that basis you say, well, Morrisons as a Gallaher customer would have known about the forthcoming MPI in any case and increasing the cost of Mayfair. Actually Gallaher wasn't having an MPI at this stage. This is just a scenario where levels of bonuses are being moved around on products between manufacturers' price increases. So what this looks like is not so much a scenario where there is a price list floating around and everyone knows what is happening on the Gallaher brands, it looks like a situation where you have picked up some intelligence about what's happening on the Gallaher brand from some of your other customers and you have passed it on to Morrisons?

A. I am not sure. I mean, that could have been as a result of what Justin told me at Morrison.

Q. One of you seemed to be passing intelligence to the other?

A. I don't know. I mean, I've written in the letter "Following our meeting on Friday, the issues we discussed, I understand", so that could quite well mean that I have had some intelligence directly from Justin, it might be supposition, it could be a whole range of things.

Q. A bit further down you say:

"As you are aware, your competitors' shelf prices have been a little higher but they would also be moving to 3.65."

That does appear to be you giving Morrisons some intelligence about what's happening in its competitors, doesn't it?

A. I am not sure. Again, that could have been part of the conversation we had at the meeting.

Q. I think it probably was part of the conversation you had at the meeting, but I am just saying that you are going to have a better idea what's happening to your brands in Morrison' competitors than Morrisons, I am saying it looks like it's coming from you?

A. No, I don't agree with that. It wouldn't have been

something I would have discussed with Justin. He may have mentioned it to me, it may have been a conversation between he and I.

Q. He mentioned to you that ITL's brands were going up in his competitors? It just looks like something which would have come from you rather than the other way around.

A. Can you just explain again what you are trying to say, because I am not sure that I follow it necessarily.

Q. Okay. The paragraph as discussed, the last sentence of that says:

"As you are aware, your competitors' shelf prices~..."

And this is talking about L&B and JPS?

A. Yes.

Q. "... have been a little higher at 3.63" and we actually saw that in the Sainsbury's document a few moments ago. But they would also be moving to 3.65. So it looks as though you are giving him reassurance that his competitors are going to be moving to 3.65 as well.

A. I don't recall that particular piece of intelligence, but I suspect it was like all intelligence, it could have come from various sources but it might well be as a result of that conversation I had with Justin on that Friday.

Q. Sorry, I do not understand, in what direction are you saying the intelligence went?
A. Well, he could have told me.
Q. He could have told you that your brands were going up in his competitors?
A. I am sorry, I am confused. Right. Your competitors.
Q. So the "your" is Morrisons?
A. Right, I thought you were referring to Gallaher. Right. So --
Q. Sorry, perhaps I should have broken it down.
THE CHAIRMAN: Well, perhaps I can help. What this looks like it's doing is anticipating an argument from Morrison to the effect, "Well, we don't want to go up to 3.65 as you are asking us because our competitors are at 3.63" and it seems that you are saying to him, "Well, don't worry about that, although they are currently at 3.63, they will be moving to 3.65 in the same way as we are asking you to move to 3.65".
A. I see. I understand, I understand.
THE CHAIRMAN: It looks as if you are giving him that bit of information to head off at the pass an argument from him as to why he might not want to put his price up to 3.65. Is that a fair summary?
MR WILLIAMS: It is, Madam, yes, I didn't think that was a deeply controversial thing.

THE CHAIRMAN: Let's find out. Does that help you recall whether actually that is what you were saying, or where did that information come from?
A. It seems as though that's what I was saying. Whether I knew it to be the truth or not, I don't know, I can't remember, I mean, there were a lot of conversations where you would insinuate something without actually knowing it, to try and do exactly as you say, to sort of chivvy them up, or reassure them that they weren't going to be out of kilter in the marketplace, that particular instance I don't remember it exactly.
DR SCOTT: Just remind us, which relationships were you dealing with at this time?
A. In 2000 I suspect that would have been Tesco, maybe not Tesco. Well, obviously Morrison, Sainsbury and Tesco, I think.
MR WILLIAMS: In your statement you say 1997 to 2004 Sainsbury, September 2000 to May 2004 Morrisons and the same for Tesco.
A. Yes, so Tesco, Morrison and Sainsbury.
DR SCOTT: So in the sense that you were in touch with Tesco and Sainsbury and you had colleagues who were in touch with others --
A. Yes.
DR SCOTT: -- you might well have been in a position to

know that parallel letters might be emanating to other retailers suggesting parallel moves?
A. Yeah, I mean, that could be where the intelligence -- not necessarily from letters but conversations.
DR SCOTT: Communications?
A. Communication.
MR WILLIAMS: You do say in your statement at 142, "This was speculation on my part and I didn't know what the other retailers' prices were actually going to do." Obviously you didn't have a crystal ball.
A. No.
Q. But presumably you believed this to be correct, useful information; you wouldn't have damaged your relationship with Morrisons by giving them misinformation?
A. I wouldn't knowingly want to lie to them, but I might suggest something that would be to my commercial advantage that wasn't strictly true.
Q. We have just seen that you wrote to Sainsbury on the same day about the same thing. In the letter, reading this letter in conjunction with the Sainsbury's letter which we have just put away, I think what we can deduce is that the move from 3.60 to 3.65 is designed to restore a 16p differential. Do you remember that from the --
A. I do remember that from that letter, yes.

Q. With Mayfair at 3.49?
A. Yes.
Q. This is just for the Tribunal: when Mr Goodall was cross-examined, I think a question was asked about whether 3.65 was a post promotional price. I wasn't going to go through all the documents with Mr Matthews, but what we see in the period prior to this, L&B and JPS were around 3.59 to 3.61 and then there was an MPI in August, so it looks as though what might have happened is that the MPI was held on L&B and JPS. If you want the references for that, they are 17/3, 17/6 and 17/8. That gives you a picture of what's happening at that time.
What you say about this document in your statement in paragraph 144, do you want to just read the last sentence of 144.
(Pause)
You say you would have had no objection if they had kept the price down, but what the letter says is, "Can you increase the shelf price from 3.60 to 3.65?" It doesn't say, "We are reducing the bonus and no longer funding a price below 3.65", it says, "Could you increase the shelf price". So it doesn't look as though you would have had no objection if they had kept the price low. It looks as though you wanted them to price

at 3.65.
A. But why would I have objected?
Q. The reason you would have objected is because you had a strategy of pricing at parity, pricing these brands at parity or at fixed differentials?
A. If it was better, I would get more share.
Q. Well, I am not going to debate the economics of this with you, Mr Matthews, I am just putting to you what the facts show. The facts show that you are asking, in this instance Morrisons, to increase their price up to 3.65 in order to restore the 16p differential?
A. But again I would say perhaps at the point of repeating myself that -- two things: firstly, that this just is showing the natural mathematical outcome of them doing that. They could say no. They could make a point "we don't want to go up yet" and very often you would have periods where they would use anything they could in their armoury to prevent it from happening.
Q. They didn't say that, they actually did put the price up in due course, but that's not really the point I am getting at. The point I am getting at is: what were you seeking to achieve?
A. I was seeking to reduce my investment.
Q. I am just putting it to you that this document says:

"Could you increase the shelf price. This will mean

a removal of the additional retro bonus."

So the document says that the price point to restore the differential comes first and the reduction of the bonus is a means to that end?
A. I would say it's the other way round, that my -- you asked me what my strategy was, and my intention, it was to produce my investment.
Q. You would accept it's not the other way round in the letter?
A. I am not sure. I think that a lot of these letters are written knowing that that is probably going to be the outcome because the supermarket isn't want to going to then sacrifice cash margin, but that doesn't mean that they wouldn't be free to do so. And that would happen. On this instance, as you say, that didn't happen but I can think of quite a few -- a lot of instances, I am not going to reference them directly, but other large supermarkets where that wasn't the case, and there were huge arguments that went on for weeks about investment, not only did they want to maintain the shelf price but they wanted the investment as well, and sometimes you would end up paying for it.
DR SCOTT: Your witness statement emphasises, I think on more than one occasion, that they were very focused on margins.

A. Yeah.
DR SCOTT: And I understand that you are focused here on reducing your investment, and so I do see that there is a chicken and egg, but what's being put to you is that the way the letter is written is "you put up the price, and you will retain your margin even though we are going to reduce the investment"?
A. Yes.
DR SCOTT: Looked at from your point of view, you could be saying "I need to save some money, they need to retain their margin, therefore they must put the price up". Now, what's actually happening here is you have done the mathematics very carefully so that the price matched by your reduction investment is that particular price that you mentioned in the letter.
A. Yes.
DR SCOTT: And your expectation of what's going to happen, because they are very worried about the margin, is that they will actually do what you suggest.
A. Yes, you are right, with every material particular, but there were lots of instances where it didn't happen. Perhaps that isn't relevant to the question, but --
THE CHAIRMAN: Where what didn't happen?
A. Where they wouldn't have put their prices up.
MR WILLIAMS: We did see this morning that the differentials

were consistently right.
A. I am talking in general multiple supermarkets now and from time to time Morrison. Maybe it was a timing issue rather than an absolute one, but yeah, I mean, they were as keen to maintain their cash margin as I was, as you say, to reduce my investment. So I suppose there was a sort of a symbiotic relationship there.
Q. Do you want to then just look at the section of the letter that starts "Price movements Richmond", do you see that in the middle of the first page?
A. I do.
Q. If you read down to the middle of the next page where it starts to talk about 100 multipacks, you can stop there.

(Pause)

A. Stop at that point?
Q. You don't need to read about the 100s.

(Pause)

A. Okay.
Q. So the only point I wanted to put to you is that here, if Dorchester is at 3.28, you want to be at 3.28, if it's at 3.29 you want to be at 3.29, and in both cases you are asking them to price at that specific price rather than that price or a lower price?
A. Well, I've said I've assumed a shelf price and that assumption is, I suppose, based on the conversation

piece with the gentleman that, you know, I assume he wanted to meant or save his cash margin and I wanted to decrease my investment. So I've made that assumption to illustrate -- sorry to interrupt -- again that sort of maths of the situation, which you are absolutely right were fairly fine-tuned.
Q. So if they were at 3.29 you want to be at 3.29, if they are at 3.28 you want to be at 3.28?
A. I am not sure that's what I am saying. I am not sure that's what I am saying. What I am saying is that I want to reduce my investment and I want to reduce it by that much. If I reduce it by that much and you want to maintain your cash margin and I make the assumption that's where your price will be.
Q. I do understand that all of the bonuses are designed to maintain margins depending on where the price is, I do understand that.
A. It's quite an important point that they were, because the supermarkets largely worked on cash margins, so I was always -- and you know, many of these letters are drafted with that in mind, because that's what drove their business.
Q. So the bonus you pay depends on what is a factor of the shelf price?
A. Yes.

Q. And here if they are at 3.29 you will pay a bonus that will maintain their margin at 3.29 and you say, "Please reduce these brands to 3.29" and if they are at 3.28, you will say, "I would like to be at 3.28 necessitating a further increase to maintain cash margin". So you will pay the bonus to achieve the price you need to achieve to achieve parity?
A. Certainly in this instance we seem to want to be at that price.
Q. At that price?
A. Yeah, because that differential was very important, they were both very key brands at the time.
Q. We know that this price change happened because we have already seen the next document in the sequence where prices went from 3.29 to 3.34?
A. Yeah, I mean, in an instance where you are offering a supermarket the ability to reduce the cost of their products to their consumers, it's very rare for them to argue with that.
Q. The next document in this sequence I want to go to is 28, but before we go there, can I just ask you some questions about the schedules on varying costs, bonuses and margins.
You deal with this in your statement, or these documents, at 131. Do you want to read that to

yourself?
A. I will. (Pause). Okay.
Q. So you say in here, amongst other things, that the prices in the schedules were set by the retailer?
A. Yes.
Q. I understand the idea that the price was ultimately set by the retailer?
A. Yes.
Q. But we saw earlier under the second trading agreement that you paid Morrisons a bonus to price in accordance with the schedule?
A. Right.
Q. So I was just wondering whether it can be right to say that these are just the retailer's prices, because if they were just the retailer's prices, presumably you wouldn't have been paying them a bonus to price in accordance with them?
A. Can you say that last piece again, please?
Q. I can. We saw earlier on that under the second trading agreement, you paid Morrison a bonus to price in accordance with the schedules, and what you are saying in 131 is that this was the price set by the retailer, and I am just asking: well, they can't just be the retailer's choice of price, otherwise you wouldn't pay them a bonus under the second trading agreement in order

to do it?
A. I go back to what I was saying earlier today that two, I think important points, the first is that those schedules reflected both ongoing and tactical bonuses, and the ongoing element was in part for prices below RRP, and secondly that those schedules were largely audit trails and that the prices keyed into them were the prices that we found having walked through the doors of the store. So they weren't dictations. I do not believe that. I believe that those were the prices the retailer chose that we were paying for beneath RRP and from time to time tactical bonuses, that is my understanding of what those schedules represented.
Q. I am sorry to press you on this, I don't understand the answer you have just given. All I was saying is that they can't simply be prices that are the retailer's choice of price, because if that were right it would make no sense that in the second trading agreement, you say "We will pay you a bonus to price in accordance with the schedule"?
THE CHAIRMAN: Are you talking about two different schedules here?
MR WILLIAMS: I don't think so. Sorry. Pricing schedules such as the one sent on 9 January 2001. Perhaps we ought to look at it to make sure we are talking about

the same thing, and that's at tab 17, that schedule. If you just look at the first line, we don't need to get into the detail of this for the minute.
A. In the schedule?
Q. No, in the cover letter. If you look at the first line and then read down to the end of the first point.
A. Sorry, this is the "please find attached a new schedule of costs bonuses"?
Q. That's right, yes.
A. Right, I've read that.
Q. Have you read to the end of point 1?
A. (Pause) right.
Q. So I think the way I read "the following changes have been made", you have made some changes to the schedule and what we see in point 1 is that the changes are designed to restore a pricing relationship, it looks like a differential --
A. Right.
Q. -- between Embassy and Regal on the one hand and B&H Silk Cut on the other?
A. Yes.
Q. So you have changed the schedule there to include a price which will restore a differential?
A. But isn't there a point before that, and isn't this the point, the difference between ongoing and -- I've

forgotten the word now -- ongoing and tactical bonuses. To get to the tactical price there has to be a price established by the retailer for that brand. So for example using this product as an example, Embassy and Regal 100s and 200s, the retailer, for reasons best known to themselves, has decided to sell this product at, I don't know, £20 or £18, and we had paid a bonus based on the price that they had established.
Q. That's the tactical bonus, I do understand that.
A. Yes.
Q. We are now --
A. In danger of agreeing --
Q. Mixing up a number of different points.
A. Okay, right.
Q. I understand the context of all of this is a reduction in tactical bonus and an apparent move in a Gallaher brand, that's the background. Just in terms of the mechanics, what's happening here is you are changing the schedule, you are changing it to include the price that you want to see to restore the differentials.
A. No, I am changing the schedule to make sure it reflects the investments that I want to make, so when somebody turns round to me three months later and says "Why did you pay this against this volume" I would be able to say "This is why I did it and this is my audit trail".

Q. Okay, but what you say in the statement about this document is:
"ITL then recorded the selling price or retail price which was set by the retailer."
A. Yes.
Q. I am just saying that this is not an instance of you including a selling price which has been set by the retailer, it's including a selling price together with a package of bonuses and all the rest of it that are designed to achieve a particular shelf price that's designed to restore a differential.
A. I hope I am not making a fool of myself when I say -- maybe I am just not listening properly or I don't understand the question, but at that retail price we talk about is at some stage before any retro bonus has been applied surely based on the price that the retailer has decided to sell at and that the ongoing bonus on top affects that. It's not me setting the price. The retailer set the price. I've paid a tactical bonus to achieve something, and it's reflected in the schedule. Perhaps -- am I getting confused here?
DR SCOTT: I think if you go back, if you remember what we saw in Mr Eastwood's statement --
A. Yes.
DR SCOTT: -- he seems relatively content because what's

happening is they expect to be below RRP, they expect to make a certain margin, and their experience is that since you want differentials associated with RRPs, and you are prepared to support a certain margin, then their normal experience is that they can retain their margin because you will support that at a level normally related to the RRPs and then if there is a bonus situation they will move and they will keep their margin because you will put in the relevant support. When you take the support away, then they move the price back up and retain their margin. I think that in mathematical terms in the Morrison case, it seems relatively straightforward.
Now, what's going on is how do we interpret that in terms of the trading agreement, but in mathematical terms, in Morrison's case, it seems relatively straightforward. They, from your evidence, seem unlikely to set a maverick price unless they make a mistake, because they are pretty clear about margins. That's what your evidence says. Is that right?
A. Yes.
THE CHAIRMAN: Is this the case: looking at the page which is stamped 58, the column that says "Selling Price", is it your evidence that that is the selling price that Morrisons have told you somehow that they want to sell

the product at --
A. Yes.
THE CHAIRMAN: -- and in relation to those items amongst the items on this page, where you are paying them a tactical bonus, you have altered that figure to show them that you intend that, because of the tactical bonus, the price they previously told you they would be selling at will now be a lower price because they have accepted the bonus?
A. Exactly. Absolutely.
THE CHAIRMAN: Before you have done your changes, in 123 on page 57, how did you get hold of the prices that are in that selling price column?
A. By going into the store and collecting them.
THE CHAIRMAN: I see.
A. So, as I think has been mentioned today, we had a team of tactical merchandisers, I think that's what they were called, and they would call every six or eight weeks in stores and that information would be downloaded into our computers. And these prices sort of developed over years. Sometimes there would be maverick changes, but largely this was a result of years of negotiation, of changes in various tactical and non-tactical bonuses.
THE CHAIRMAN: You gleaned what these prices that are in that column are from your market research, as it were,

and then you sent them this to say "Well, we are paying you these bonuses, these extra bonuses in relation to these things, and we have taken the liberty of reflecting that in changes on those items" --
A. Yes, that's what I was trying to say, very ham-fistedly, but exactly that.
MR WILLIAMS: I think where we had got to there is that the price we see in the schedule is the price that you have put in there in order to restore the differential, making adjustments from the base price?
A. I think that's what I am saying, yes.
Q. So --
A. The base price being set by the retailer.
Q. Could we turn to another example, at 26, please.
A. Yes.
THE CHAIRMAN: Sorry, could I ask one more question in follow-up just on that.
The changes that you would make to the prices that were in that column gleaned from the market research, would you make a change in order to restore that price to a differential as per those trading agreement differentials, or would you only alter that price if you were giving a tactical bonus in relation to that product?
A. That's a good question. What would generally happen is

that you would get that information from the computer and then, if there was something that looked odd, the phone call would be made and dependent on the buyer's commercial guile, there could be lots of different outcomes. But if it meant paying a bonus to change that price, that could be reflected in that schedule. It tried to -- what you would hope for is that that schedule reflected what our aspirational pricing was. If it didn't, you would have opportunities to make a move or not.
MR WILLIAMS: Could you turn on to document 26, please?
MR HOWARD: Sorry, could I clarify one thing arising out of your question. As I understand what was happening at tab 17 in the case of Embassy and King Edwards, the witness ought to clarify but I think what was happening was a retro bonus was being withdrawn and so it's not a case of a bonus being paid and then the price being reduced, it's the bonus being withdrawn, I think, but perhaps he ought to just clarify that and how that works in relation to the schedule.
THE CHAIRMAN: But I was asking more generally whether changes made to the prices coming from the computer, as Mr Matthews has put it, were made only in relation to tactical bonuses or were made more generally to restore P&Ds.

MR HOWARD: I understood that, but your question I think was in the context of a bonus being paid and a retro --
THE CHAIRMAN: I see, yes.
MR HOWARD: Maybe it's obvious, it's just the other side of the coin.
THE CHAIRMAN: It's another side of the coin.
MR HOWARD: The particular examples we have actually are retros being withdrawn, it's not retros being added, I think.
MR WILLIAMS: Do you have got 26?
A. I do.
Q. Do you want to read through. I am most interested in the third point.
(Pause)
A. Okay.
Q. So this seems to be a different situation where you have amended the schedule without having had a discussion with Mr Eastwood in relation to the 25 gram pack, because you say a shelf price of 3.84 would give you a parity position. We can see over the page that you have the price of 3.84 in the schedule?
A. Yes.
Q. So you were happy to amend the schedule to include the price you wanted to see, even if it hadn't been agreed with Morrisons?

A. Knowing Grant as I did, he would be very quick to tell me if any assumptions I had made were wrong.
Q. But you thought the assumptions you were making were probably right?
A. Similar to the document we were discussing five minutes ago when I used the term "I assumed". I think in this instance when you are offering support, as I said before, to a large retailer to reduce price, they are going to be happy with them.
Q. We see at point 5 --
A. Yes.
Q. -- "Please allow the shelf prices of L&B, JPS to increase by 7p."
So here you are doing what you did in document 17, which is working out what the price will be absent any retros. I think point 3 is an example of a situation of you just adding in the bonus without having had a discussion. It's not just --
A. It's an assumption that I made that I think that he would be happy to agree to.
Q. That's right. Can we then turn to tab 28. {D17/28} I am afraid this letter is a bit less self-explanatory, but do you want to read it to yourself?
A. Yeah. I will, and I know this document.
Q. Yes.

A. I'll do my very best to describe what this -- is that what you are asking me to do?
Q. No, I'll put to you my understanding of it.
A. Okay.
Q. I am focusing on the fourth period and Richmond, because Richmond is stable, I think, until the fourth period, it stays at 3.34 in the first three schedules?
A. Stable?
Q. The price is 3.34 in the first three schedules and then the fourth schedule says "Richmond 5p shelf increase"?
A. Right.
Q. Do you agree or know whether this is a price change which is designed to implement parity between Richmond and Dorchester?
A. I don't know. I do know that this was a -- or I am just familiarising myself with this, it was some time ago, but I seem to remember that this was rather a tricky set of circumstances where I am covering both things that have happened and things that are going to happen as a result of an announced Chancellor's increase on tax, and it seems to me as though we are trying to implement some tactical holding against the prevailing increase that the Chancellor is levying on cigarettes, and that we are trying to hold down the cost or the shelf price of Richmond against that Budget. That's my -- I am

making a few assumptions that are actually very dangerous, but that's what it looks like.
Q. Focusing on the fourth period, it says "Richmond 5p shelf increase". If you turn over the page, I am afraid I think the schedules are in the wrong order, Imperial can tell me if that's wrong, but if you look at the first schedule and you look at "Richmond Kingsize", you will see that the shelf price is 3.39. Then if you look at the next schedule and look at the shelf price, it's 3.34. Actually it's one penny higher in Superkings, which is often what you see. 3.40 and 3.35. Okay?
A. I am just trying to work out for the sake of my own sanity which, if they are in the right order because I would have expected to see post Budget costs ...
Q. I think the rest of them are 3.34.
A. Are they?
Q. So I've assumed they are in the wrong order or at least --
A. I think that's possible.
Q. -- the 5p increase is from 3.34 to 3.39 because that's the only 5p increase we see.
A. So what was the question, sorry, I am lost trying to work this out?
Q. I was asking you whether this was a price increase that was designed to restore parity between Richmond and

Dorchester, and this is a letter 6 April and the fourth schedule covers the period from 9 April.
Could we look at a document in annex 7, please, you should have a confidential version that you can show Mr Matthews. It might be that we --
THE CHAIRMAN: Well, is this going to say what the Dorchester price --
MR WILLIAMS: It does, it says -- perhaps I will get my copy --
THE CHAIRMAN: Perhaps do we need to take him to it?
MR WILLIAMS: There is a document 10 in annex 7. It is a fax to Grant Eastwood from Gallaher. {D7/10}.
Perhaps Mr Matthews doesn't need to see this, perhaps it's enough for the Tribunal --
THE CHAIRMAN: Well, quite. To put a schedule to a witness who's not from that company and say "It says 3-point whatever" a bit is pointless.
MR WILLIAMS: I take your point, madam. But we see that there was at that time an increase in Dorchester from 2.339 with effect from 1 April.
Would you agree on that basis that what you are doing in the letter at tab 29 is communicating with Morrisons about a price increase which is going to restore parity between Richmond and Dorchester?
A. I can't be sure, because I can't remember the context of

this. I really can't remember the context of this.

MR HOWARD: If it helps, I don't think the context is controversial. I've shown you the documents and we actually have that schedule that was helpfully prepared by, I think, whoever it was, maybe it was the Morrisons team, which shows when the MPI came in, and what you have actually seen at tab 26 is that the price was then held. There was a 6p price increase and the price was held on Richmond by a bonus and then this seemed to be withdrawing it.

THE CHAIRMAN: We have asked Mr Matthews whether he can remember why that was dealt with, whether it was in order to achieve parity with Dorchester, and my understanding is that that may have been the reason but you can't remember the particular context of that?

A. I can't remember the context.

MR WILLIAMS: I am grateful, madam, I don't know if that's a convenient moment for a short break?

THE CHAIRMAN: Yes. We will take a break now and come back at 25 past 3.

MR HOWARD: Could I just say, I am sorry to interrupt, that at say, 4.25, we can discuss some timetabling issues.

THE CHAIRMAN: Yes.

Mr Williams, just to remind you again not to discuss your evidence with anyone whilst we are on a break.

Thank you.

(3.20 pm)

(A short break)

(3.35 pm)

MR WILLIAMS: Mr Matthews, before the break we were looking at the document at tab 28. You deal with this at paragraph 134 of your witness statement, albeit you deal with it in a bit of a list. Do you want to have a quick look at that. The reference to this document is PM1/39 in the penultimate line.

(Pause). Really the reason for taking you through that in some laborious and tedious detail was simply to make the point that although you talk about this in simply mechanical terms in 134, you talk about what was happening in terms of the bonus, but really what was happening there was a price increase to restore parity between Richmond and Dorchester.

You say you don't know what the Dorchester price was, but that's really what was happening there.

A. Is that a question or a statement?

Q. It was putting to you --

THE CHAIRMAN: Do you remember whether --

A. No, I don't remember.

THE CHAIRMAN: That's where we got to.

MR WILLIAMS: Could you turn to tab 31, please, in file 17.

{D17/31}. Can you turn to the second page. Feel free to cast your eye over the whole letter. (Pause).

A. Right.

Q. On the second page I am interested in point 2:

"As per the message I left some weeks ago your current shelf prices on our cigar brands are still below those outlined in the last schedules. All brands are 6p below where they should be."

You discussed this at paragraph 150 of your statement. Do you want to just refresh your memory of what you have said about it?

A. Yes. (Pause). Okay.

Q. You are saying the first document shows that Morrison was in charge of its own pricing and I think the point you are making was that they didn't do what you asked them to?

A. I think what I meant by Morrison being in charge of their own pricing is that they, not Imperial Tobacco, decided what shelf prices to adopt.

Q. But the letter says:

"All brands are 6p below where they should be."

So plainly you thought they should be somewhere else?

A. I am not sure I agree with that, and the reason I say that is because the schedule served several purposes, as

I've said before it was an audit trail, it was also the basis from which we may or may not make tactical adjustments, but it was also what Morrison told us they were going to do, so if I was in a store and I saw that something wasn't reflected in the store that was on the schedule I felt duty bound to discuss that with the buyer. When I say in that letter "all brands are 6p below where they should be", they doesn't mean below where I think they should be, but where Morrison told me that they wished to price their products.

Q. So a bit further down you say:

"Secondly it was commonplace for ITL to check the actual shelf prices charged as huge sums were spent on bonuses?

A. Yes.

Q. "Morrisons claiming a bonus which was not payable would lead to ITL overpaying large sums of money."

A. Yes.

Q. So this letter, with the one we were looking at, has laid down a marker, you would say, should they want to claim a bonus for you. Do you want to turn to tab 32.

THE CHAIRMAN: Can we clarify, I thought you had said earlier that the prices in this column under "Selling Price" were arrived at from the observations that were made in store.

A. Yes.
THE CHAIRMAN: So where did you get the point that you have just made, namely that you knew that Morrisons' policy was to price 6p higher than the prices that you had observed in the stores?
A. I think there is two reasons: firstly you could have stores that I had visited where that wasn't the case, and in that instance the buyer would say, "Well, that's the Wednesfield store, they are always getting it wrong." That's possible. The second is that when the key prices on a weekly basis, they could make mistakes in that or change things or various things could happen which means what we believed we would see in the store wasn't the same as it should be, or what we saw at the store was different from the schedule I should say.
So in this particular instance I have been in the store, I've got a schedule, I think something has happened. Some evidence has told me that is the case, something may have changed, and I wasn't aware of it; in other words, Morrisons have decided that they want to be more aggressive on cigars and they wouldn't have to tell me if that was the case, or I have been into a store and I have seen an anomaly, or maybe one or two stores and that's what I'm drawing the buyer's attention to. I don't think it's meant to say where they should be,

where I'm dictating the price should be, that is an observation that I have made.
MR WILLIAMS: Can we look at tab 32 then, please. {D17/32}.
A. Yes.
Q. I am only interested in the bottom paragraph. This is a follow-up note or memo a few weeks later:
"I have not looked this week but I assume you have increased shelf prices as per my last two schedules."
A. Right.
Q. So you have already covered yourself against the claim for a bonus with your last letter, haven't you? They can't possibly say after the last letter that you have left them in any doubt about where their prices ought to be?
A. Right.
Q. Do you agree?
A. Yeah, I may be taking this out of context, I am not sure if this was a brand that I was paying a bonus on or not. The point I was making was perhaps more of a general one, that the prices on the schedule as I have established are ones that we collected data on, but from time to time mistakes were made and the mistake I am alluding to, whether in this case I was planning a bonus or not I don't know, was that I had been in the store, you have told me you are selling something at £5, it's

actually at £4.95, you ought to know about it, because you could be robbing yourself of a cash margin, and really that's all I was trying to outline.
I mean, I can't remember this exact instance but I do remember, even though it's more than -- ten years ago, that Grant or Morrison were selling something below the price they were telling me they were selling it at and I just brought it to their attention. The shelf prices of saying cigars, in the plural. I mean, we didn't pay bonuses on cigars, I don't think and I am reasonably certain that's what it relates to.
Q. The only point I was putting to you a moment ago was you can't explain this note on the basis that you are protecting yourself against some claim for a bonus because your last letter was on the record. So if there were any chance of them coming back to you and saying, "Can you please pay us a bonus because we have been pricing at whatever level" then there is a paper trail on that now, isn't there, of the letter of 19 June?
So the letter at tab 32 is obviously doing something different, and I think what I am putting to you is that it's you telling them where you thought their prices should be in the context of your trading agreement with them?
A. I respectfully suggest it's me telling them that what

they have told me isn't the case, but that's my -- I can't be sure to which brands it relates to, unless I've missed the thread here.
Q. Do you say you were telling them that they ought to increase their prices --
A. No.
Q. -- solely in their interests?
A. Yeah. Or -- and it could be in my interest, I don't know the brand that I am talking about, but if for example -- I am trying to think of a good example -- that they were under the impression that I was prepared to pay something and I hadn't agreed to it, that would put me in difficulty. Equally if they were selling something beneath the price that they decided to, they were making less margin. Either way, there could be an issue, either I would end up paying or they would be claiming money from me I hadn't agreed to, or they would be making less cash margin because they would be selling it at a shelf price less than they thought they were.
DR SCOTT: I thought earlier on you had said to us that selling too cheaply was what you were looking for, that you would rejoice, that they were free to do it and you would rejoice.
A. I think that generally speaking, yeah, but in this instance -- and again I may be very wrong -- I thought

I was actually doing the buyer a favour here, and you try and use any tactic you can to try and get commercial advantage. I think generally on cigars it's less of a competitive business, but that's my recollection of it, that I was informing him, he wasn't doing something he thought he was. I don't know what else to say about --

MR WILLIAMS: What this shows is you complaining to Morrisons that their prices are too cheap and the only reason you would do that is because you wanted your prices to be at a certain relativity to the Gallaher brands.

A. I can't agree with that on either count I am afraid.

Q. Can we turn on to tab 41, please. Just read that to yourself. {D17/41}.

A. Yes. (Pause).

Q. So this is talking about various holds at MPI time?

A. Yes.

Q. Just to understand what that means behind the scenes, would you agree that when you hold a brand at MPI essentially what you are doing is deferring the wholesale price increase, so you have a list price increase but you basically take it away again through a tactical bonus?

A. We are foregoing any potential benefits from an increase

in our own margins, that's the first thing that's happening if we decide to do that, so we have to balance it within our own portfolio. But effectively we are doing -- as you said, the prevailing price has gone up and I am going to continue to charge a lower price.

Q. In the paragraph starting "We are also looking at holding Richmond Kingsize".

A. Yes.

Q. So the prices we have are 3.39, 3.40, so I am assuming given that you were usually 5p above Sterling, that they were at 3.34, 3.35, not that the detail matters for the purposes of this. What you say is that whilst Sterling is at whatever price it's at, you want Richmond to stay where it is, but if Sterling goes up, you want the shelf price of Richmond to go up?

A. Well, we would certainly like to balance our investment, it's quite a big deal, if you have an increase, this is how tobacco companies make their money in the UK, they are able to leverage on price, if you have made a decision to do that and then you hold brands as big as Richmond and as Superkings, that's a big call, it's a huge investment and you take that pretty seriously, so if there is a chance of perhaps not doing it as much as you need to, you would take that. So I think what this refers to is that it's not so much a shelf price, it's

an investment that I'm concerned about and the company would have been concerned about.

Q. What it says is "of course if the market price for Sterling moves up, we would wish to do the same" --

A. Certainly wish not to continue to overinvest in that brand.

Q. But that isn't what it says, is it?

A. It doesn't say that, no, I can't deny that, it says it here.

Q. It is like all the other documents really, it says what you want is the price to go up?

A. I think that there is an important point behind that, that it is also about the margin that we make, and the investments that we make.

Q. I don't suppose you are going to remember what happened next in relation to particularly the price of Dorchester.

A. I must confess I don't.

Q. I'll just tell you, this is a letter dated 13 August, on 15 November Sterling went up to 3.39, and with Superkings at 3.40, so assuming it was at 3.34, 3.35 before with a 5p relativity, it looks like it's going up 5p.

Against that background can you turn to tab 50. {D17/50}. There is no comment on Richmond in the letter.

If you turn over to the schedule, we can see that at this stage Richmond Kingsize is at 3.44 and Superkings is at 3.45.

A. Right.

Q. So this is 19 November, which is just a few days after Sterling went up 5p, so we see Richmond going up 5p, so 5p differential reinstated. While we are in this document, if I pause on Richmond, could you turn back to the cover page?

A. Yes.

Q. Under Cafe Creme, Cafe Creme Mild, this records that you agreed to reduce the price of Cafe Creme to parity with Hamlet?

A. Yeah.

Q. Again the agreement is that it will be in line rather than at that price or a lower price?

A. Okay.

Q. Coming back to Richmond and Sterling, I think you are 5p above them at 3.44, 3.45. The next instalment of the story is that Sterling Superkings go up to 3.42, so up 2p, and that is on 25 February, so a few months hence. Could you turn then to tab 56, and just read that to yourself.

A. I've read that.

Q. So the first thing we see, I think, is that you

discussed the price, the increase in Sterling before it happened, because it says "Forthcoming Sterling price moves". Do you agree?
A. It seems as though I have had a conversation and Paul has told me, yes.
Q. You decided that you would increase the price of the Superkings by 2p as well to 3.47, so that tells us first of all that the last move to 3.45 had happened?
A. Yes.
Q. And you wanted to go up another 2p to reinstate the 5p differential with Sterling?
A. That's what it says in that document.
Q. So we have a situation where you are within 5p on Superkings, on Richmond Superkings, of Sterling Superkings, but you say that you want prices to increase anyway to exactly 5p more than Sterling?
A. Right.
Q. So what you were doing in these letters is communicating with Morrisons about price increases that were designed to reinstate your parity and differential requirements upwards as well as downwards, the differentials weren't ceilings, as you say in your statement, they are fixed intervals. Time after time you tell Morrisons that what you want is them to increase prices to reinstate the differential and Dorchester goes up?

A. But they don't have to do it, though.
Q. Well --
A. But they don't.
THE CHAIRMAN: That's a different point. The point is: is this email reflecting a conversation in which you and Mr Eastwood agreed that that was what would happen with Richmond Superkings?
A. Yes, that is the point of the conversation, what happened in the conversation I don't recall. I also notice that the multipacks continue to be price marked, I am not sure, but it's possible that we would have continued on lower prices on Richmond Superkings in the multipacks.
MR WILLIAMS: Can you turn back to --
A. Which might have been -- sorry to progress the --
Q. No, carry on, please.
A. That might well have been as a result of trying to get a competitive advantage on multipacks. In fact, I think it was, at the time. Because we would have held the price on multipacks and perhaps gone up on the 20s.
Q. Can you turn back to paragraph 134 of your witness statement. You have already looked at this in relation to document 28. You lumped this document in with 16 and 28.
You say you would normally discuss these bonus and

price changes with Morrisons and that correspondence was just confirmation of that discussion, but actually this document is just about the shelf price, it's not about the bonus at all, it says "I've asked Graham Plummer to create a new schedule to reflect this change."
A. Yes, but isn't that following the conversation?
Q. It is, but the point is that you are not --
A. The notes are perfunctory --
Q. The point is that you are talking about shelf prices before you have even worked out what's happening in terms of the bonus?
A. I've talked about shelf prices --
Q. You are discussing shelf prices, what's going to happen on the shelf price before you have even worked out what is happening on the bonus, this isn't a discussion about bonuses, it's a discussion about shelf prices?
A. But the two things are mutually inclusive.
Q. Yes, but what you say --
A. Aren't they?
THE CHAIRMAN: What's being put to you is that other letters that we saw included a discussion of the bonus, the change to the bonus and how that would affect their margin, and when you were looking at those, you said "Yes, really we only pointed out to them what the shelf price would be because we were changing the bonus, we

knew they wanted to retain their margin, and hence, as a matter of courtesy really, because we were withdrawing the bonus, we pointed them to the shelf price they would need to move to"?
A. Yes.
THE CHAIRMAN: Whereas here you are saying "We would like to move the shelf price up" and that doesn't seem to be referring to any change that you have already decided to make to the bonus, this letter doesn't refer to the bonus or the margins or anything.
A. No.
THE CHAIRMAN: It just seems to say you have agreed to move the price of Richmond Superkings up because Sterling prices are moving up.
A. It's a very functional letter, but there may have been a conversation about margin and about benefit prior to this being written.
THE CHAIRMAN: You don't recall?
A. No, I don't.
MR WILLIAMS: Do you accept that in this series of letters that we have been looking at, we can see that ITL's strategy of maintaining parities and differentials was a strategy that worked in both directions, you weren't just making sure that your brands stayed relatively cheaper than or no worse off than the Gallaher brand,

you wanted your brands priced at a fixed relativity to the Gallaher brand, and that's what you do in these letters time after time?
A. Sorry, can you just start the point again?
Q. I am really just putting to you that we have seen a whole series of letters in which, from which it's clear that ITL's policy of ensuring that certain differentials were maintained between its products and Gallaher's products, that policy didn't work as a price ceiling, it worked so that the fixed interval, the fixed differential, a parity relationship, a fixed 3p relationship, whatever it was, that interval was in place at all times. That's what you are doing, that's what you are making sure happens in every one of those letters?
A. That was the point of the trading agreements, to try and achieve those pricing relativities.
Q. Could you turn to tab 67, please? {D17/67}
A. Yes.
Q. There is a letter here which attaches a draft of the trading agreement?
A. Yes.
Q. I just wanted to look at the bit of it that relates to differentials. So could you turn over to 445?
A. Yes.

Q. Just read the first three paragraphs to yourself.
(Pause)
A. Okay.
Q. You will see the word I wanted to emphasise there is to replicate the price list differentials, then down at the bottom of the page it says "as at September"?
A. Yes.
Q. There is a list of price list differentials?
A. Yes.
Q. And they are not expressed in the same way as the ultimate draft of the second trading agreement because it doesn't say at least 2p cheaper than or whatever?
A. Right.
Q. It just lists them as specific intervals. I just wanted to say, do you agree that that document reflects the way in which the parities and differentials worked in practice?
A. Which one, the final one or this one?
Q. This one, the draft.
A. I suppose it was a draft document and knowing that, it wasn't as full and as well written as the final one. But your question is --
Q. What it says is "replicate the natural price list differentials" and then the differentials are expressed in a different way?

A. In which, in the final document?
Q. In this document, focusing on this document, it says "Replicate rather than reflect".
A. Yes.
Q. You might say that is dancing on the head of a pin, but anyway.
A. You might.
Q. Further down, the differentials are not expressed as 2p cheaper than or whatever, it just says "minus 2p parity", and all I was asking: do you agree that this idea of replicating these differentials is actually how the trading relationship worked in practice?
A. Replicating the differentials?
Q. So to put it in the context of the documents we have just been looking at, if you had a differential of 5p between Richmond and Sterling, you wanted prices to move so that you were 5p more expensive than Sterling rather than at least 5p more than?
A. Well, it would be better if we were more than 5p, wouldn't it, clearly?
Q. That's not what I was asking you, I was asking whether this document reflects the way it worked in practice?
A. In practice sometimes, in other times not, but ...
Q. In practice, you wanted Morrisons to replicate the differentials and you wanted them to replicate specific

differentials rather than maximum differentials?
A. Based on the prices they chose to sell at, we would make bonuses, and we wanted commercial advantage over our rival manufacturers, and this is what we thought commercial advantage was.
Q. You don't get a commercial advantage by making sure you are always at parity with them, you just make sure you are always at parity with them?
A. Well, we wouldn't be commercially disadvantaged, and that's what we were trying to avoid. Because if we were worse than parity, parity is -- well, parity is parity. If we were above that, we would be commercially disadvantaged.
Maybe I am dancing on the head of a pin now, but there is a big difference; if you are at parity and then you are not at parity, you are going to have a problem. if you are better than parity, clearly that could be to your advantage.
Q. This document doesn't talk about being better than parity?
A. It doesn't talk about it, but it's draft.
Q. I understand that it's draft, but all that occurs to me is that you have been working on these accounts for some time, you are familiar with the way that they work, if you thought that these were price ceilings, it's hard to

see how you would have written this up in the way you have written it up. You have said that you want to see the differentials replicated, and you want the specific differential, and it's hard to see why you would write up the document in this way -- in draft, in draft -- if your experience of running the account was that these were price ceilings?

A. I would say again it's a draft document and I am sure there is quite a few loose phrasings in it, whether it relates to pricing or not. I don't think this precludes or would seek to preclude a retailer doing his own thing and giving you more advantage if he so desired to do so. I don't think we could stop that.

Q. It does, though, doesn't it? Because replicating a differential of parity is different from saying "We would be happy if we were one penny below"?

A. It's different in the way that it's written, but we would have advantage, wouldn't we, if we were better than that?

Q. Well, you would have advantage but that's not really what I am getting at.

A. Why would I want to stop us having advantage?

Q. What I am putting to you is that what this document shows is that when you sought to write down and capture what ITL was doing, what its strategy in relation to

differentials was, this is the way you saw it. You saw it in terms of replicating specific differentials?

A. Maybe I am just re-emphasising the point too much, but anything better than that is going to be better. It doesn't mean that that wasn't -- the retailers weren't free to do that. That's what we would consider desirable, but you know, there is different degrees of desire, I guess, and when you could get commercial advantage, that would be beneficial, because then if you were better than parity or 6p not 5p, you would hope that a consumer would notice that and that you would gain for a period of time some share from competitor brands. I would be foolish to say you couldn't do that.

Q. Do you understand the distinction I am drawing, though, between effectively differentials which give rise to price ceilings and fixed differentials?

A. Yes.

Q. Do you agree that the way this is written up reflects what we have just seen you doing in practice, which is making sure that specific differentials are always in place?

A. But I go back to the point I made a few hours ago that these trading agreements were firstly a basis for negotiation, secondly, they weren't written to be legally binding, I don't think even in this case that

they would have been seen by anybody but myself and maybe my immediate supervisor, and I think we recognised there was a degree of fluidity in the market and in those accounts. I mean, I know the textual analysis is important, I appreciate that and I respect that, but I would say that, you know, this was not a document that went that much further than junior management.

Q. Do you know if there was legal comment on this document?

A. On this particular document?

Q. Legal input?

A. I am almost certain to say no, but I don't recall that specifically.

DR SCOTT: Just one question: you said this document was not seen by anybody in ITL apart from yourself and maybe your supervisor, but as we understand it, the strategic pricing requirements weren't particular to Morrisons they were being set from above, so you would receive guidance as to what ITL was looking for.

A. Yes, absolutely right.

DR SCOTT: Now, were you seeking to reflect that guidance in the arrangements that you were seeking to make with Morrisons in particular here? Though presumably with Sainsbury's as well in parallel.

A. If I was able to achieve those differentials, that's good.

DR SCOTT: So that matches the requirement of your strategic colleagues.

A. Yes.

DR SCOTT: Thank you.

MR WILLIAMS: Could we just turn back to tab 85, please, which is the second trading agreement. {D17/18}. I just wanted to look at a provision that we didn't look at before. Under the heading "Pricing" again, the second bullet point "With the exception ..."

A. Yes.

Q. It says:

"With the exception of the application of either Budget or manufacturer price increases, Imperial Tobacco investments should reduce in line with any upward movement in shelf prices."

Would you agree that, bearing in mind the series of correspondence that we have just seen, you wouldn't reduce the bonus that would be paid to Morrisons if they increased prices to restore your preferred differentials?

A. Sorry, say that again?

Q. We have just seen a lot of documents in which you say "We want to maintain parity with Dorchester, therefore please put our prices up", and I am asking you: given that we have seen that you did that on many occasions,

you wouldn't expect to take away a parity or differential bonus payment from Morrisons if they maintained the differential by increasing the price of your brands? That was something you wanted to see them do?
A. I might be on the wrong track here, but I think that that point there is to protect against price creep towards or potentially above RRP, and there is a particular reason I use that, that was getting my fingers burned somewhere else.
Q. Absolute prices?
A. Yes. So what I was trying there is saying, "Look, I am paying bonuses, there is an absolute element to this. There is a sort of an agreement here that I make this much, you make that much; if you start to profiteer [if I can use that word] I would like to share some of the spoils", and that's really what that was talking about.
Q. Thank you. Could you turn to tab 58, please. Do you want to read that to yourself. {D17/58}. I think you comment on this in your witness statement so you are probably familiar with it.
A. This is the Philip Morris price increase note, yes.
Q. That's right, yes, although it's not is much that bit that we are interested in, it's the bit underneath it.
(Pause)

A. Okay.
Q. So the background here is that Gallaher has published an MPI?
A. Yes.
Q. And you haven't?
A. No.
Q. And you say that the result of this is that the differentials will widen?
A. Yes.
Q. If we look at the way you express them, you say "Moving from minus 3p to minus 9p" and so on?
A. Yes.
Q. Draft agreement we were just looking at a few minutes ago?
A. Yes.
Q. You expressed them in that form rather than as price dealings.
You say that you expected to see prices which implemented the new differentials. I think this is consistent with the evidence you have given that you would expect to see Morrisons pricing in accordance with your differentials?
A. I do remember this reasonably well, and you are absolutely right, this was when our arch competitor had decided to increase their prices and Philip Morris who

we were supporting in the UK, we have a distribution agreement with them, had agreed to do the same.
THE CHAIRMAN: Slow down a bit. I think the transcriber is probably struggling.
A. So Gallaher are going up, Philip are going up, we are not, so commercial advantage, for that period of time we are going to be not just differential, we are going to be differential plus. It might be that an enterprising supermarket might try and put everybody's brands up at the same time to be avoided because if they do, we lose two things: they are effectively taking our MPI early and they are making brands, they are increasing the product's price to consumers when there is no need to. So this was -- I suppose I was getting my retaliation in first and explaining: listen, we are not going up yet, we are not going up, so make sure we don't put our prices up and it's a very long-winded way of saying that, to be quite frank.
MR WILLIAMS: That's right. I am interested in the way you expressed it, because what you said to Morrisons was that you wanted them to implement new differentials.
A. Well, I don't think it would be a case of implementing new differentials, it would be to make sure that they don't implement anything, that this is really a letter saying "If the status quo is allowed to continue, we

will have an advantage. I would like that advantage, and please don't disadvantage me".
Q. You are quite right, what you wanted them to do was to respect new differentials rather than implement new differentials?
A. I just didn't want them to put our prices up.
Q. You didn't say that, though, you said:
"I would expect to see the following example disparities from the date you implement our competitor's price increase" and you express it in terms of a widening of differentials?
A. Yes, I did, and that's what it says there, but I'll say it again just so I make it clear, "We are not going up, please don't put the products up. If you do as you are doing, this is what we will see", and that is it.
Q. That would have been a much more straightforward letter to write, wouldn't it?
A. It probably would.
Q. Between two business people?
A. It would have been a much more straightforward letter to write. I didn't. I used this particular idiom. But that is exactly what I meant.
Q. I am suggesting that the reason you wrote the letter in these terms is because you had an agreement with Morrisons that they would respect certain pricing

differentials and your concern was that if you didn't articulate new differentials, that they would proceed on the basis of the old differentials and that's not what you wanted?

A. What I did not want is to, for a customer to profiteer from a situation that they shouldn't be and that's what this is about. Differential or no differential, there was a pool of money being shared at the time which both parties were comfortable with, and had Morrison or indeed any customer at the time decided to declare UDI and put prices up at the same time, that would be a bad outcome, and that's what I was trying to avoid, and this is why I wrote that letter.

Q. Morrisons was benchmarking itself against its rivals, wasn't it?

A. I think that Morrison, like the other multiple supermarkets, had a sort of favoured other retailer they would match themselves against, I think that's fairly plain, yes.

Q. You weren't having an MPI anywhere at this stage, were you?

A. Well, you only have one, so no.

Q. If Morrisons had chosen to put your prices up, then they would have risked putting themselves at a competitive disadvantage against their rivals, wouldn't they?

A. They would, and it would be a mistake all round, because they would lose out to their own rivals and it would be a no win situation. And I think in truth the chances of that happening are slim, but you just felt compelled to put something in writing, so if my boss said to me "Paul, I've just bought my prawn sandwich from Morrisons and, horror of horrors, they have gone up" at least I would have something to defend myself against those accusations with, and that's what that letter represents.

Q. I don't know if you know what actually happened while you were writing these letters, do you remember Gallaher actually instituted a set of price holds so that effectively --

A. I don't remember that.

Q. -- their prices remained, and this is a bit of a simplification of a complicated situation, but their prices on a number of brands were made at the same level as yours. We don't need to go to the documents in relation to that. What you did then was I think simply to leave your prices where they were. Do you recall that?

A. I don't recall it but it would seem -- I mean, that's what we might do from time to time if we were having a manufacturers' price increase, like the document we

saw earlier with Morrison where I think we were holding Superkings and L&B and the prevailing increase we would try and hold some brands to get our margin mix to try and gain advantage. I don't know, they quite possibly could have done that, held a couple of brands.

Q. The only thing I am getting at really is that in that situation, if they held their prices and you left yours where they were, which is what I think has actually happened, then it's not really clear that you did want to see increased differentials at all, really, is it? Actually you were just leaving your prices where they were, because you didn't then say, "Actually, we want to be 4p under, can you reduce our prices by 4p?"

A. That's exactly what I was suggesting earlier, that we weren't going up, and if we are not going up and they are, this is what you would see, we are going to get a win from it. Can I have my win, please? That's really all I am saying here.

Q. But you didn't get a win?

A. Well, I don't know, because you asked me if I knew what had happened while I was writing these letters, I don't recall that specifically, if you are suggesting to me that they went up but didn't go up on a number of brands, we wouldn't have got a win on those brands, but they didn't hold on all of them, did they?

Q. They didn't hold on all of them, no.

A. So we would have got a win, wouldn't we?

Q. No, but the point is that on most of the key brands, on Richmond and Dorchester and all the rest of it, what we see is a continuation of the price relationship we see before, but if you don't know what was happening on Dorchester then we can't explore that.

A. I don't remember that specifically.

Q. Can we then just turn over to 63, {D17/63} to complete this sequence.

A. Okay.

Q. Do you want to just read that to yourself?

A. Yes. (Pause).

Q. In fact you can stop at the end of the first page actually because it then moves on to a different topic.

A. Okay. (Pause). Right, okay.

Q. So now you issue your MPI, and you communicate some new differentials again, and these are again expressed as specific intervals rather than as price ceilings; you see that?

A. I think this was, I have some recollection of this for many years we believed that the optimal pricing relationship between, for example, Embassy and Benson & Hedges was a 3p differential, somebody in the clever sums department had changed their mind, so a new

price list was issued with a smaller differential, and I am pointing this out to Paul.
Q. Yes, but the differential you describe is minus 3p, changes to minus 2p rather than --
A. Yes, so we were prepared to live with a smaller differential.
Q. Your prices are going up, relatively speaking?
A. I suppose you could say that, yes.
Q. We will come back to the second page of this letter.
A. Okay.
Q. One last topic I wanted to cover today, if I can, and then I think we will have a little bit more to finish off next week. This is Morrison's strategy, we have seen Morrison's strategy already, it's maintaining low prices and remaining competitive against its benchmark competitors, and we have seen that alongside that strategy Morrisons agreed to support your strategy.
You are nodding. It doesn't show on the transcript. I think you need to say "Yes", that's all, if you agree.
A. I was nodding because I was thinking about what you were saying. I didn't actually mean I agreed with it, I was just nodding.
Q. Let's start again and see if you really do mean to nod.
We have seen Morrisons' strategy in the documents we were looking at earlier on, and that's to maintain low

prices and remain competitive against this benchmark, broadly speaking.
We have seen that in the trading agreement, Morrisons agreed to support your strategy, and I think you said that when you formulated your strategy it was intended to work alongside Morrison's strategy?
A. I don't think I did say that. I might have done, but --
THE CHAIRMAN: Which part of that do you disagree with --
A. It's the last part, that I formulated a strategy to -- I can't remember the phrase that you used.
MR WILLIAMS: Shall we go back to document 23, because that's where we talked about it.
A. Okay.
Q. We saw on page 193 Morrison's strategy?
A. Yes. That's me saying Morrison's strategy is clear.
Q. That's right, yes, but I think that's in the confidential box, I am not sure how confidential it really is, but anyway turning on to page 200, then you discuss your strategy which we have already looked at. Really all I said was you obviously had Morrison's own strategy in mind when you were formulating your strategy, and I said that the two have been designed so that they tend to work alongside one another and my recollection is that you said yes, which is the sense of this document?

A. They must do if they were prepared to sign an agreement. I suppose the bit that I was perhaps in disagreement was as though they work in complete concert, and they weren't always.
Q. No.
A. It's probably just me being obtuse, I didn't mean to.
Q. I understand.
You say in your witness statement that your strategy was consistent across all the retailers you dealt with, so you were dealing with Tesco and Sainsbury, you had basically the same strategy in relation to them?
A. We sought to reflect price list definitions and gain competitive advantage through the minimum possible investment and make the most possible money, that would have been my strategy in all of those accounts.
Q. I think you also say in paragraph 18 that:
"If ITL had a promotion it would apply across a range of retailers including those whose accounts I did not manage".
Do you want to look at it for yourself?
A. 18?
Q. That's right, yes.
(Pause)
A. Okay.
Q. So really I am getting at a fairly straightforward

point, which was that there was a consistency in the way that ITL dealt with the retailers and specifically like retailers like Morrisons and its competitive set?
A. I think when it came to supermarkets that was the trade sector that was the most difficult, and I do think there was a difference in the way that we dealt with the supermarkets, I think they were much more difficult to negotiate with, and because they had made this intention or had an intention to sell at lower prices they demanded more investment, and they were difficult from time to time.
Q. But you were pursuing the same strategic objectives with all of Tesco, Morrison, Sainsbury?
A. Are we talking about just pricing now?
Q. I am talking about just pricing, I beg your pardon.
A. Because there are an awful lot of other things that we did try and do. Maybe that's not for now. As far as pricing was concerned we did look to reflect those differentials, but we were also always, particularly with Tesco, I am not sure if it's worthy of mention, very, very keen to keep a close eye on that sort of joint margin pool and, I would refer back to the point I have made many times, that that relationship between absolute pricing and investment was important with all of them.

Q. The same thing was happening with the other big supermarkets that you weren't dealing with like Asda, Co-op or perhaps you don't have direct knowledge of that?

A. I never manage -- I was a bit of a specialist on grocers, I am afraid, so I didn't have a great deal of experience outside those. They all came with different issues and different problems.

MR WILLIAMS: That's where we have gotten to, Madam, I know Mr Howard wanted to discuss timetable.

THE CHAIRMAN: Yes. How much longer do you think you will need to have?

MR WILLIAMS: I think I can finish certainly within an hour, I would have thought.

THE CHAIRMAN: Right.

Mr Saini, will you have any questions?

MR SAINI: I think I will have about 15 minutes of questions for this witness.

THE CHAIRMAN: Difficult to know at this stage, but any ideas as to re-examination?

MR HOWARD: I anticipate, I am not certain, possibly an hour or so.

THE CHAIRMAN: Well, that's all we have time for this afternoon, as they say, so I am afraid we will have to keep you from Florida a little bit longer.

A. I knew that this would happen, despite advice.

THE CHAIRMAN: The only thing I can say is that it looks like it's lovely weather out there, so you are not being too gravely disadvantaged by staying on this side of the Atlantic. In fact, it's Tuesday that we will re-start, because Monday is a non-sitting day, and it will probably be 10.30 although we might need to have a discussion amongst ourselves. Again, as you are in the middle of your evidence, you mustn't speak to anybody about it between now and Tuesday, except someone may need to tell you what time we are starting on Tuesday. But for the moment, you can leave the witness box and we will just discuss some logistical matters.

(The witness withdrew)

Discussion re timetable

THE CHAIRMAN: On Tuesday, then, we will be completing this witness and then going on with Mr Eastwood.

MR HOWARD: Yes.

THE CHAIRMAN: At some point, Mr Saini, you will want to say something?

MR SAINI: I was going to say it before Mr Eastwood gave evidence but we want Mr Eastwood to be able to leave by the end of Wednesday at the very latest, so subject to that, I did want to make a few observations.

THE CHAIRMAN: Yes. Mr Howard.

MR HOWARD: Sorry, I didn't realise Mr Saini was standing up. I just wanted to make some points really about the timetable in the sense that, as I see it at the moment, we are, at least on the way the current timetable is set out, about two and a half days off. Tuesday was a slightly odd day in that we didn't actually have any factual evidence, so assuming we are using that, we are about a day and a half off.

If you go forward to 3 November, that's when we are due to start with expert evidence. I mentioned to Mr Lasok that one solution at the moment is that we use that day as a further fact day, and we therefore start the expert evidence the following week. The reason of course I am particularly concerned is that my experts are coming first and one of whom is coming over from the United States, so that we would like to do that. If we knock things on by one day, that means that we need to use probably or certainly 18 November, which is the reserve day. So that's really what I wanted to check, (a) whether the Tribunal was content and (b) whether at least those in court believe that is right.

The other point is I think in a letter in response to the OFT's request for further time in relation to expert evidence, I think there was some question as to whether any time was going to be used in the week of

21 November. Of course, if we do do that, then we may need to think about how that knocks on in terms of the subsequent timetable, and again I am looking at it particularly from my perspective in that we have to go first in oral closings and we wouldn't want to start oral closings before you and we have had sufficient at this moment to absorb the written closings.

If we work on the basis that we are going to finish live evidence on the 18th and we are just going to slip by a day, I think we can stick with everything else.

THE CHAIRMAN: Yes. As regards to the start of the oral closing submissions, there has been some mention of there being a strike on 30 November, which may force us to take an extra day with considering the written closing submissions anyway.

There is a lot of time left at the end of the timetable, which gives us some flexibility. At the moment it's difficult to see how the factual evidence could be speeded up, given how it's been conducted so far.

The only additional point I would make is that we all on the panel are a little concerned that the opening submissions in relation to each of the appellants have become rather more extended than we envisaged when we had the idea that those would be useful.

Certainly as regards Shell and the Co-op and Morrisons, those are three rather distinct retailers --

MR HOWARD: That's right.

THE CHAIRMAN: -- and we were hoping that now we are moving on to counterparties who are more similar to each other, more similar to Morrisons, we might be able to shorten the opening.

MR HOWARD: Certainly we anticipate for Safeway and Asda there is a lot less we will want to say by way of opening.

THE CHAIRMAN: We would ask you really to focus on any points of difference in those, rather than reiterate the main case.

MR HOWARD: I appreciate that. First Quench, T&S and TM Retail fall into a different category, so it's just maybe that one of those will require a little amplification. Somerfield has peculiarities of its own relating to the nature of the evidence.

THE CHAIRMAN: Well, peculiarities are what we want you to focus on, rather than the more general case.

MR HOWARD: Yes. I'm conscious that we took slightly more time on Morrisons, but the distinction was, in the case of Morrisons, we have actually taken you through the documents so it's actually meant that the cross-examination and re-examination may be slightly

shorter.

DR SCOTT: I was just going to say one small thing: earlier in the day you didn't know what an MRG was; I think it's a multiple retail grocer, and that came up in a later document. That's just so that we get it in the transcript what an MRG is.

MR HOWARD: I am grateful.

THE CHAIRMAN: Can we start at 10.30 on Tuesday or would it be better to start at 10?

Mr Saini, it's your Mr Eastwood who --

MR SAINI: I think 10 would be safer as far as our witness is concerned.

THE CHAIRMAN: Well, we will say 10.15, that makes things easier for some of us. Very well, thank you. Mr Howard?

MR HOWARD: I think it's clear, but I am just being asked from behind whether we are agreed, therefore, that the economic experts will start on 8 November rather than 3 November? Ie that we are slipping --

THE CHAIRMAN: Yes, I think we will take that decision, and also say that it does look like that certainly Mr Shaffer will need to be available on 18 November as well as earlier than that.

MR HOWARD: Yes. It also has the effect that you will have one week of appellant's experts and one week of OFT

experts, which may make things at least easier to manage and think about.

THE CHAIRMAN: Yes. Thank you very much, everybody. We will meet again then at 10.15 on Tuesday.

(4.35 pm)

(The court adjourned until 10.15 am on Tuesday, 18 October 2011)

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