IN THE COMPETITION APPEAL TRIBUNAL

Case Nos. 1238/3/3/15

Victoria House,
Bloomsbury Place,
London WC1A 2EB

14 December 2015

Before:

ANDREW LENON QC
(Chairman)
WILLIAM ALLAN
PROFESSOR COLIN MAYER

(Sitting as a Tribunal in England and Wales)

BETWEEN:

BRITISH TELECOMMUNICATIONS PLC — Appellant

- and -

OFFICE OF COMMUNICATIONS — Respondent

- and -

SKY UK LIMITED
TALKTALK TELECOM GROUP PLC

Interveners

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HEARING - DAY FOUR

A P P E A R AN C E S

Mr. Rhodri Thompson QC, Mr. Nicholas Gibson and Ms. Anita Davies (instructed by BT Legal) appeared on behalf of the Appellant (British Telecommunications Plc).

Mr. Josh Holmes and Mr. Tristan Jones (instructed by Ofcom) appeared on behalf of the Respondent.

Monday, 14th December 2015

(10.30 am)

MR. DAVID HAMISH CURRY MATTHEW (continued)

Cross-examination by MR. THOMPSON (continued)

MR. THOMPSON: Good morning sir, good morning gentlemen. Good morning Mr. Matthew.
A. Good morning.
Q. When we finished on Friday, we were discussing the issue of the constraints that were applicable to BT, as it were, independently of this debate. I just would like to look now at the position that would have prevailed as a matter of SMP regulation had this condition not been applied. You were in court when Mr. Clarkson was cross-examined, I believe, Mr. Matthew?
A. Yes, I was.
Q. And you may recall a debate towards the beginning about the position between June 2014 and March 2015 and whether there was any margin regulation in place during that period, do you remember that?
A. In general, yes. I can't remember the full details.
Q. Do you recall the consultation process in this case?
A. Which one?
Q. Both in relation to FAMR and in relation to this particular condition?
A. In relation to this condition, then, yes. In relation to the Fixed Access Market Review prior to that, I wasn't the economic director on the case at that stage.
Q. That is helpful, thank you. But you will recall that there were four options considered in the present consultation and that they went back to earlier options that had been identified back I think as far as 2013, do you remember that?
A. Broadly, yes.
Q. Can we look at the FRAND condition itself, which is annex 29 to the FAMR review document, which is at III/II, tab 8. It's a long document, and if you turn right to the back and then we can work backwards ...
A. Which annex did you say?
Q. Tab 8. So if you go to the back of tab 8.
A. Yes.
Q. Then do you find a pink sheet a few pages in?
A. I have several pink sheets.

Q. Just go back to the last one, as it were.
A. Yes --
Q. You should find part 3, "SMP Conditions", and then do you see 1.2 and 1.3?
A. Yes.
Q. 1.2 says:

> "The provision of network access by the dominant provider in accordance with this condition ..."

Which is (b), and then you jump on to (b)(1):

> "Be on fair and reasonable terms, conditions and charges."

Do you see that?
A. Yes.
Q. And then 1.3 there is an exception in relation to condition 6 or 7, do you see that, where any of conditions 6 or 7 apply. Do you see that under 1.3?
A. Yes.
Q. I don't think we have them in the paper, but 6 and 7 are in fact the charge control provisions. So what it says is that 1.2(b)(1):

> "Fair and reasonable terms, conditions and charges."

And then 1.3 is an exception, and if you look at 1.3.1 it says:

> "Fair and reasonable terms and conditions excluding charges ..."

Do you see that?
A. Yes, I see it.
Q. So I can just explain it to you. The position is that where there is a charge control then that governs the charges position, where there isn't a charge control 1.2 applies. Do you see that?
A. I will take your guidance on this. I am not particularly familiar with this.
Q. That is fine. If we now go into how the matter was dealt with in the final statement, that is in the previous bundle, III/I, and if you turn to page 68, paragraph 4.68, you see a reference to option A, do you see that?
A. Yes.
Q. "We consider that option A (which relies on the existing requirement on BT to provide VULA on fair and reasonable terms, conditions and charges, supplemented with guidance on how we intend to undertake our assessment) ..."
Do you see that? So what would have happened if option A had been adopted is that the FRAND condition would have been used supplemented by guidance, do you see that?

A. Yes.
Q. And that is our 1.2. Do you remember that the scope of this investigation --
A. Sorry, 1.2?
Q. You remember we looked at condition 1.2 just a moment ago which dealt with conditions and charges?
A. Yes ... I don't -- we are jumping between a condition in -- that is the FAMR statement, right?
Q. Yes.
A. And the VULA margin consultation ... they are both talking about fair and reasonable terms, but I ... I am afraid I just don't --
Q. I'm sorry about this --
A. I'm not really able to offer any opinion on whether this is linked to this or what the precise connection would be. It's not something I --
Q. I will try and make it clearer. I will look at the condition that was actually done in a moment. But do you remember that the scope of the exercise you were engaged with was limited to retail consumers, it wasn't concerned with business, do you remember that?
A. In terms of the VULA margin connection?
Q. Yes.
A. Yes, I think that is right.
Q. One sees that at 4.116, which is at the end of 4, page 78:

> "We note that as a consequence of implementing the VULA margin control in a new SMP condition, we are removing the fair and reasonable charges obligation in the WLA market insofar as it relates to the VULA margin with respect to the packages offered by BT Consumer."

So that is retail packages, yes?
A. Yes, and the footnote explains --
Q. Yes, that the FRAND condition would still apply to BT business packages as well as other VULA terms, conditions and charges, yes?
A. Again, I will need to take guidance. It looks like it here, but again, that is not at the forefront of my memory.
Q. And then when you look at the detail of this, this is at 5.60, page 94, the treatment of business services, and then there's an introductory explanation:

> "At the wholesale level, the basic connectivity VULA used to support residential and business services is the same."

A. Sorry, which?

Q. The fourth line down:

"At the wholesale level, the basic connectivity VULA used to support residential and business services is the same."

Do you see that?

A. Yes.

Q. Then there is a distinction drawn about the different conditions. And then there was a question about whether or not the VULA margin approach should also apply to businesses and Vodafone was arguing in favour of that, if you see that at 5.63?

A. Yes, I see that.

Q. Then at 5.68 is the conclusion. Ofcom says:

"We don't believe it would be appropriate or proportionate to consider an extension of the VULA margin assessment to include superfast broadband services supplied by BT business at this time ..."

Then it goes on:

"The fair and reasonable terms, conditions and charges, VULA obligation, will continue to apply to BT business services as set out in section 4. As such, if we were to observe behaviour in relation to the margin on VULA-based business services which raised concerns, or indeed any other pricing concerns, we could consider intervention on the basis of this condition to address such behaviour."

So what that is saying that the FRAND condition still applies in relation to business and controls margins, is that right?

A. Again, it seems to read that way, but it is really not my area.

Q. But you were the economics director for this so presumably this analysis was put past you, is that not correct?

A. In broad terms, but I am afraid I just can't recall this. It is not what I have been preparing for this --

MR. HOLMES: Sir, I hesitate to rise, but none of this cross-examination appears to relate to the evidence that Mr. Matthew has given. All of these points can be made by way of submission rather than by putting questions to Mr. Matthew.

MR. THOMPSON: Sir, I'm --

THE CHAIRMAN: I'm not quite sure where this cross-examination is going, but Mr. Thompson, what you do say?

MR. THOMPSON: The point was put to me by Mr. Clarkson effectively without any warning, and so we have an Ofcom witness here. If Mr. Clarkson wanted to come back and discuss it

with me that would be fine. But Mr. Matthew was fully engaged with this matter, he was the economics director for this, and presumably he had to sign off on these --
THE CHAIRMAN: What point do you say was put to you by Mr. Clarkson?
MR. THOMPSON: Do you remember the issue about whether or not the FRAND condition actually applied between June 2014 and March 2015 which seems to be -- it appeared as a submission in the Ofcom skeleton argument which took us by surprise, it had no source, and then Mr. Clarkson made the point on legal advice, as he said, which we haven't seen. So I am simply going through the point so we understand where we are coming from.
MR. HOLMES: Sir, this is a legal issue that can be canvassed in closing submission.
THE CHAIRMAN: It does strike me that it is a legal point, Mr. Thompson. I'm not sure Mr. Matthew is going to be able to help very much.
MR. THOMPSON: Okay. Can I simply for the Tribunal, since we have got this far, give you the references to where it caches out, as it were. It's the second annex to the final statement which you find towards the back. I think it's the last of the pink sheets towards the back of this same tab, and in particular it is page 9, paragraph 24.
Do you want to turn this up, Mr. Matthew, so you can follow what is going on? Turn to the last pink tab.
A. Sorry, I was -- where is it?
MR. HOLMES: Again, sir, I don't understand why it is relevant to show this to Mr. Matthew.
THE CHAIRMAN: Just give us the list.
MR. THOMPSON: It's page 9 of annex 2, paragraph 24, and the amendment is to 1.3, and it extends the exemption in relation to the VULA margin which is defined in the following page, page 13, so that it is limited to retail services.
The point that I am putting to you is had option A been adopted, which presumably is something you considered because you were the economic director in relation to this matter, then the FRAND condition would still have been the margin squeeze control without any need for a legal change. That must be correct, that is what it says here.
A. Yes, option A was FRAND plus guidance.
Q. Exactly. So the FRAND condition would simply have stayed unchanged. I am simply putting it, perhaps in a slightly cumbersome way, that that is the position in relation to business customers, so that is the point.
A. Business I don't know about, but in terms of the FRAND condition with guidance, obviously we were concentrating on what the guidance ought to be, and for me the substantive question is what should the nature of the constraints on BT be in terms of what costs it

ought to recover, et cetera. The precise way in which that is implemented by condition wasn't my particular focus.
Q. No, but you were presumably cognisant of the business debate and the point that was made by Vodafone, to that extent you were aware of it?
A. Sorry, I was speaking about consumer. As to business, I have already said I just cannot immediately recall.
Q. If we move back to more home ground for you and look at the issue of incentives. Would you accept that if an incentive exists independently of any question of a margin squeeze then that is not an incentive to engage in a margin squeeze?
A. Could you put the question again? If an incentive ...
Q. Exists independently of margin squeeze, so it's something that arises in the market anyway, then it is not an incentive to engage in a margin squeeze?
A. So in logic there are two different reasons why I may wish to do something --
THE CHAIRMAN: I am afraid the Tribunal doesn't understand that question. Can you rephrase it?
MR. THOMPSON: Perhaps if I make it more specific and we will see how we get on.
Would you accept, in relation to Sky and TalkTalk, that if they have reasons not to move to superfast broadband independently of any pricing by BT, then that is not a reason why BT might engage in a margin squeeze, at best it's neutral and you might say it was converse in that why should BT do that if they are not going to get it anyway?
A. I suppose -- an analogy might be let's suppose, by assumption, Sky or TalkTalk had just decided for completely different reasons they are simply not going to be involved in superfast broadband, then I would agree that on that assumption there would be -- well, essentially what BT does would make no difference to their conduct because, by assumption, we have said they are not involved in superfast broadband.
Q. For example, if Sky and TalkTalk were making greater margins on standard broadband than on superfast broadband, then that would be a reason for them to stay with standard broadband rather than to move to superfast regardless of any conduct by BT?
A. It wouldn't be regardless of BT's conduct, because the choice you have just set out would depend on the VULA margin and the VULA price.
Q. Yes. But if there were independent reasons, and I discussed it with Mr. Clarkson, for example regulatory choices by Ofcom which made standard broadband more profitable than superfast broadband, that is independent of anything BT might do?
A. Yes, so I agree with you that TalkTalk or Sky, when they decide how far they should promote

superfast broadband to their customers or in acquiring customers, obviously they will take into account other factors as well, such as when they are thinking about how much should I put into upgrading my customer base? They will take into account the profitability of standard broadband subscribers and also superfast. The latter of course would be affected by the VULA price.

Q. In relation to BT, would you accept that BT could have a legitimate first mover advantage in superfast broadband given that it has invested substantial sums in order, in part, to meet competition from Virgin who obviously led off with superfast broadband, would you accept that?

A. I certainly agree that BT could do very well early on with superfast broadband by pursuing legitimate commercial and competitive objectives, and the evidence we have before us is that they are doing exactly that, they have a very strong early position, it is expected to get stronger over the next couple of years, and that has been in conditions where they haven't been implementing a price squeeze.

Q. Yes. You refer in various places to a strategic focus that BT has had on superfast broadband, and in itself you wouldn't have any objection to that?

A. No, quite the contrary. BT promoting superfast broadband is good for consumers and in particular many of the investments it has made in doing that, sports rights and so on, have been a significant addition to the nature of competition in the modern marketplace.

Q. Yes. I think the first thing you said on Friday, it is right at the beginning, page 62, for the note, you said:

> "The fact that they are vertically integrated ..."

So BT is vertically integrated with Openreach:

> "... leads BT Consumer to have quite strong incentives to drive sales of superfast broadband and that may lead to quite a low superfast broadband price as a consequence."

So that is all pro-consumer, is it not?

A. Yes, so if that is leading them to set low prices, that helps consumers. And the issue is of course whether the VULA price goes with it to allow others to also pursue the same ends should they wish to.

Q. Yes. In terms of BT's downstream investments, and I think you heard Mr. Petter's cross-examination, is that right?

A. Yes.

Q. And he talked about the launch of the Infinity brand as a premium product, that is a legitimate

initiative in itself, is it not?
A. Absolutely.
Q. And it would further create incentives for BT to drive superfast broadband. There is no point in having a premium product and then hide it in a cupboard, is there?
A. I presume it is all part and parcel of the same agenda.
Q. Insofar as it is -- you accept it as a premium product, for which one would hope to have a premium in price, a margin squeeze would make no sense for such a product?
A. I do agree a premium product would typically have a premium price. Your second comment seems to me a complete non sequitur though.
Q. It is not a complete non sequitur, is it? Normally you would think of a margin squeeze as bearing some form of sacrifice, if I can put it that way, in the short-term which would normally I think involve some form of sacrifice of profits at the retail level, wouldn't you accept that?
A. I think we think of a margin squeeze as a margin that would allow a similarly efficient operator to match the dominant vertically integrated firm's prices. It doesn't presume that we have to establish a profit sacrifice as part of that. If a margin squeeze happens for reasons that don't involve profit sacrifice I think that can still squeeze out rivals and undermine their ability to compete in the short- and long-run.
Q. We will come to the detail of the mechanism I think you are putting forward in a moment, but you will recall Mr. Petter's evidence about the profit-shifting effects and I think what you are saying is it might be a premium product and profitable but BT might shift the profits upstream. But Mr. Petter's evidence, and I don't think there is any basis to reject it, is that that would itself be a bad strategy because it would push profits into an area subject to regulation and damage the BT share price. Did you hear that evidence?
A. Yes, I heard it. Sorry, what do you want me to comment on?
Q. You said all things being equal or something, but that is a reason why having launched a premium retail product it wouldn't make much sense to shift the premium price into the wholesale price because it would damage the BT share price?
A. So, sir, I think the suggestion is that if BT raises the VULA price, relative to its retail price, then Mr. Petter observed that that will in accounting terms move profits between BT Consumer and Openreach and his evidence was that the City will tend to place more weight on BT Consumer profits and less on Openreach.
Q. Yes.
A. So by raising the VULA price, that would damage the BT share price, if I understood it

correctly.
Q. Correct.
A. Because in accounting terms it would look like BT Consumer was less profitable and Openreach more profitable.
Q. Yes. I can see you may not be an expert in corporate finance or value or anything of that kind, or maybe you are, but it may be not what you are here for. But the underlying rationale is not just some quirk of the City, it reflects reality and it in fact reflects your own evidence. If we can look at paragraph 59B of your statement.
A. Remind me where that is.
Q. Tab 12 of bundle II. In the middle where you say:

> "BT may perceive a risk that Ofcom will introduce cost plus regulation of the wholesale VULA price at some point in the future --"

A. Sorry, you will have to give me the paragraph.
Q. Sorry, page 29.
A. Yes.
Q. "BT may perceive a risk that Ofcom will introduce cost plus regulation to the wholesale VULA price at some point in the future which could require a drop in the VULA price and a corresponding reduction in the wholesale revenues earned."
That is the very point that Mr. Petter is making, is it not?
A. I think there is -- yes, I think it is, because -- well, in particular what Mr. Petter says, if I recall correctly, was essentially the reason why analysts put more weight on BT Consumer and less weight on Openreach is because when Openreach makes money they expect that to essentially fall into the regulatory pot and the returns on it will therefore be capped essentially by Ofcom, whereas BT Consumer is a free commercial business and profits it makes are potentially liable to last for longer.
So I think essentially he is making a similar point to the one I make here, which is by and large where BT Group has a choice that might affect how much value, how much money it can make out of Consumer compared to Openreach, it will tend to shade that choice and say, well, I would actually like Consumer to do a bit better and Openreach do a bit worse, all else equal.
That is consistent, I think, with the general conclusions of my report which are that BT Group has incentives to favour its consumer business potentially to a large degree. So to give an idea, if BT faces a choice -- suppose it sets a higher VULA price and perhaps makes -- let's just take an example. Let's assume that 100,000 TalkTalk customers decide as

a consequence, well, we are not -- we were thinking of upgrading to TalkTalk's fibre products but now we are not going to, perhaps because TalkTalk has raised its price or stopped sticking leaflets through their door, then the question arises what do they do? Some will stay with TalkTalk and take standard broadband and others will switch over to BT Consumer and become BT Consumer customers probably for quite long periods, five years, maybe longer.

One can look at the margins associated with those decisions and how large the diversion might be, but the general observation that when that choice is evaluated BT would think, well, actually I quite like getting more customers for my consumer business, even if there is a bit of a cost -- a bit less revenue for Openreach because some TalkTalk customers don't upgrade. According to Mr. Petter's observations and the observation here, they are liable to shade that towards Consumer.

You also asked -- I'm not sure if you asked. You passed remark on the observation that, well, obviously if BT does raise the VULA price, then in the short-run there will be a transfer of profits from Consumer to Openreach, and on the same logic I have just explained it might seem that this would result in BT Group not looking so good in the City because there is a short-run shift in profits.

You asked whether I am an expert on being an analyst et cetera and absolutely I'm not. I'm certainly not an analyst and I have never worked as one. But speaking as a -- my recollection of things such as the efficient market hypothesis and other aspects of the economics of financial markets, one point does strike me and that is essentially markets are expected to take account of public information. So when they see public information that tells them, well, this company is likely to do better, this company is likely to do worse, they should take that into account. There are many very clever, very highly incentivised analysts out there whose job it is to seek out that information, analyse it and turn it into company evaluations.

At this point I do reach the limit of my expertise, but I would just observe that if the VULA price changes and that were to result in a significant short-run shift in the accounting profits of Consumer and Openreach, it would surprise me that analysts wouldn't pick that up and recognise that Openreach is, yes, it's doing a bit better now but that is not going to last, Consumer is doing a bit worse now but actually in future it is going to do better in accounting terms because that VULA price may come down if Ofcom regulates.

So I would be surprised if the overall valuation of BT Group was seriously affected by a relatively transparent move in the transfer price.

PROFESSOR MAYER: Can I just ask a supplementary question to that? So you are saying that, equally, the City should not take too short a run of view of the profits of the consumer business. But could it not be said the effect would actually go the other way, namely, if the price squeeze succeeded in driving out competition downstream, then that would increase the profits of BT in its consumer division in the long-term, and thereby, by this very reasoning, actually increase the share price of BT? So if the margin squeeze succeeds essentially in raising the profits of the consumer business then that is beneficial, not detrimental, to the share price of BT.

A. Yes, I would agree with that, and again that is -- for me, the primary inference I draw from Mr. Petter's remarks is essentially that, that real gains, real substantive gains for the consumer business will get more weight than real losses to Openreach, and I do agree that in the long-run if BT Consumer makes more money than BT Group shares will go up on that analysis.

Of course, it might also be in the short-run. It is entirely possible that even in the short-run BT Consumer, even in accounting terms, will appear better off, well, will be better off, because if the VULA price goes up and enough people switch over and start purchasing from BT Consumer at quite high margins, that could easily outweigh the accounting loss associated with the VULA price although I wouldn't want to overstate my position on that because I have not conducted what the accounting picture would look like in that scenario.

MR. THOMPSON: Yes, and I think to some extent we are moving a little bit outside your area of expertise, I think by your own admission, and I have given you quite a long time to respond, and indeed you have answered a question from Professor Mayer on a slightly different hypothesis.

I will just take you back to the place we started with, which I think you accepted, which is that BT has launched a premium product and would expect to charge a premium price.

I think you accepted that?

A. Yes.

Q. The point I made by reference to Mr. Petter's I think uncontested evidence is that it wouldn't make sense for a price premium to be pushed into the regulated area because, by definition, it would be vulnerable to being taken away by Ofcom by means of regulation, and that is what the City thinks, and I think that is what you think too, is that not correct?

A. I'm struggling to follow the point because Infinity is a premium retail product, so I think the City's expectation isn't that Infinity or other BT retail products will fall into the regulatory pot.

Q. No, precisely not, but --
A. They are considering the VULA product is what goes into the regulatory pot.
Q. I don't want to create a disagreement. We are saying precisely that, that there has been no finding or any expectation that BT is or may be dominant or to have significant market power in relation to the retail sector. The concern is in relation to Openreach and indeed FAMR itself makes it clear that it will review the need for a price control as early as 2017. So any shifting of profits into VULA, if I can put it that way, or into Openreach, would be vulnerable to regulation as early as 2017.
That is the point which I think you have made yourself and Mr. Petter made.
A. Sorry, yes, we just discussed that. Sorry, I was just making the point that I don't understand the relevance of BT's retail positioning of Infinity as a premium retail product in the analysis you have just given --
Q. If I put it very simply. Supposing BT has a bag of gold, and Ofcom could take that bag of gold away if it was placed in one cave but not if it were placed in another cave, then BT would be more likely to put the bag of gold in the cave where Ofcom couldn't take it away, which is Consumer. Would you accept that?
A. If I understand the analogy, Infinity is a retail product. Unless Ofcom reintroduces retail level regulation, Infinity will not fall into the regulatory camp.
Q. Correct.
A. So you are not shifting gold in that sense. If it is a general observation about does BT Group place significant weight on acquiring subscribers and profits for BT Consumer, and there I mean real profits, not those that arise simply by virtue of movements in the transfer price, and places less weight on those accruing to Openreach, then I do agree with you for, firstly, the reasons in my report and, secondly, the reasons Mr. Petter gave last week.
Q. I think the issue has been fairly well aired, I will move on.
The next thing is that I think you will have heard Mr. Bishop's evidence, and indeed we started with this yesterday, about whether you agree about there being a balance of costs and benefits, and I think Mr. Bishop thinks that falls out of various guidelines issued by the EU Commission. And we thought it was agreed but you were somewhat reluctant.
If I could just take you to paragraph 13D of your statement, you say:

> "There are other factors that may influence BT's VULA pricing."

And then in the middle you say:

> "Some of these would add to the incentives to set higher VULA prices, others would moderate ..."

Which I assume means take away or reduce those incentives:

"... and in other cases it is unclear whether the factor concerned is likely to add or to reduce BT's incentives to margin squeeze."

So quite a complex picture. Some in favour, some against and some ambivalent, is that right?

A. Yes, I would agree with that.

Q. I think the critique that Mr. Bishop makes of you is that you have made no real attempt to undertake that, what looks quite a complicated analysis of positives, negatives and ambiguous. Do you understand that is the criticism?

A. Yes.

Q. For example, you set out some considerations of that kind towards the end of your report and also at paragraphs 58 to 60. For example, at 58 you basically restate the sort of ambivalence of the whole situation, pages 28 to 29. Then you make some points about reasons to doubt the costs at 59. Do you see that?

A. Yes.

Q. I think another criticism Mr. Bishop makes of you is that it is not a balanced analysis, you don't look at the other side.

A. Well, just give me a second to check back ... So 58 is in a subsection that is looking at the factors or some of the factors that Mr. Bishop emphasised. But in the preceding section from 48, paragraph 48 onwards, there is what I thought was a fairly extensive discussion of BT's retail market position and how that might be influenced by BT setting a higher wholesale price.

Q. I will come to exactly that analysis in a moment, but I think you will have heard the question from Professor Mayer, I think two questions, about what might have been done to look at this issue on a more empirical basis. Do you remember those two questions?

A. Yes.

Q. The various suggestions were made, I think Mr. Bishop described it as an excellent question and I'm sure he thought the second question was excellent as well, and he identified a number of empirical surveys that could have been undertaken of various kinds, or empirical analysis if I can put it that way. You would accept I think that you didn't carry out those surveys and analyses, that is correct, isn't it? There is nothing about it much in the final statement?

A. No, we didn't -- well, I -- certainly in the final statement we did not carry out any specific survey. I think Mr. Bishop did talk about a survey, he didn't say precisely what, but

I presume he means something like a survey of customers to try and assess diversion, destinations, the likelihood and things such as that.

Q. Yes. A table was put to Mr. Bishop about what might or might not happen, and we have tried to tidy the table up. I don't know if I can put it to you and we can discuss this issue in slightly more concrete terms. (Handed)

I think I made a couple of points to Mr. Bishop in -- do take time to have a look.

A. Yes, I think the A to E are comparable with the notes that Ofcom put up.

Q. Yes, and this obviously isn't all the possibilities because a rival might be Virgin, in which case it might be pleased, and in principle BT Consumer will also face the same price so there will also be issues for BT Consumer. But just looking at the VULA customer responses, if they respond to an increased VULA price in one of the five -- sorry, if they respond to the increase in the VULA price by increasing their retail price, then there are in principle five customer reactions which will have knock-on effects for Openreach and for BT Consumer and here, as we see it, even on the assumption that on an end to end basis it is at least neutral, there will be losses to BT Consumer in all the circumstances except -- sorry, it will be neutral in all the circumstances except one, there will be losses in one, whereas the position on Openreach is ambivalent and the overall effect is ambivalent.

The only two cases where it's clearly beneficial will be if the consumer stays with the rival, so for example Sky, and pays a higher price, in which case there will be higher VULA revenue as well and no effect on BT Consumer. Or alternatively if the consumer stays with the rival at a stable retail price, in which case BT will get higher VULA revenue but no effect on the consumer price. Do you accept that?

A. It's quite a long statement. On the latter two points I agree that where -- if BT raises the VULA price where the customer takes superfast but stays with TalkTalk, then obviously Openreach will make more money because it is getting a higher price for that sale than it otherwise would have done.

Do you want to work backwards and go through the others? Where there is -- where there is a higher price and the customer switches to BT Consumer to take superfast broadband, I'm not sure why you have incremental losses on the immediate impact on BT Consumer. I would expect BT Consumer to make a positive margin where that happens.

Q. I don't know what assumption you are making there because if it is going to be anything that is even recognisably a margin squeeze, how can that be the case for BT Consumer?

A. I think probably what this comes down to is whether we think of a price squeeze as solely about BT being able to cover its short-run incremental costs or whether it is conceived as

BT being able to cover its LRIC or its LRIC plus. The relevance of that is that if it is the latter then there will be still significant gross margins where BT Consumer acquires a customer, they will make money out of it, even if the amount of money they make in principle isn't sufficient to cover the fixed incremental costs associated with the business.

Q. The assumption is that the VULA price has gone up --

A. Yes, but --

Q. Wouldn't that necessarily reduce the Consumer margin?

A. It would reduce it, but if we start off from the situation today, which is BT Consumer will have quite high gross margins. BT's essential argument in the price control matters is that they earn quite high gross margins and that therefore the rules we're putting in place are too inflexible, we're making them recover fixed costs in a too inflexible way, but the implication is the gross margins are there.

To put concrete observations around this, in the case of for example BT Sport, which is an important part of the Consumer offer, BT's essential point is, well, if we sell more broadband customers at the retail level that doesn't increase our sports costs, because the sports costs are mostly content and those are fixed, they don't vary according to how many subscribers you have.

BT have also made other observations about other elements of their costs, so things like bandwidth costs often have some economies of scale, some marketing costs can have economies of scale. There is -- obviously we have adopted a LRIC plus model so that entails allocation and attribution of some common costs, clearly those won't vary either with the number of subscribers. So all told, BT Consumer will currently be making quite high gross margins I would think on its retail business.

So where somebody --

Q. Yes. All I am saying is if the wholesale price goes up, those margins will go down. It's not a totally controversial point, is it?

A. If we start off, let's suppose BT Consumer's gross margin is something like -- I'm making numbers up here, but let's say it's £12 a month, that is the gross margin over and above the Openreach charges that we'll assume they pay. If you raise the VULA price, say, by £2, that might be sufficient to lead TalkTalk and Sky to start focusing far less on superfast than they otherwise would do, but in terms of the transfer price, yes, BT Consumer's transfer price charged would have gone up by £2 but that would still leave £10 of margin, and when the customer moves across from Sky and TalkTalk, that transfer price movement won't make any difference anyway, they will just get £12, and that might be quite a good trade-off

for them.
Q. It's an interesting example you give because it sounds very unlike a margin squeeze because BT is still making substantial profits at the price.
A. As I said, the discussion is premised on their existing significant gross margins in the retail business and our view is that a price squeeze would occur where BT is failing to cover its long-run incremental costs and allowing a plus as well.
Q. I will come to that in a moment but it does sound a bit as if you think any sort of retail price competition is a margin squeeze but we will come to that in more detail in a moment.
Can we look at retail competition generally. You would accept that it was good in itself?
A. Yes, absolutely.
Q. And would you accept that differentiation was good?
A. It certainly can be and in particular competition to achieve differentiation can be very powerful in delivering benefits to consumers.
Q. With a vertically integrated firm you can have investment upstream or investment downstream for the purposes of differentiation, yes?
A. Yes. Let's just think though ... (Pause) To the extent that -- well, let's just be careful about what we mean by differentiation upstream. Certainly investing to differentiate BT from the Virgin network is highly desirable, i.e. we like BT to compete and by offering better wholesale products, such as VULA, it can compete better with Virgin and that is obviously desirable. But the general premise once it comes to differentiation between BT, TalkTalk, Sky and other users of the VULA products, the concept is that there should be a level playing field and BT shouldn't get significant advantages in retail competition by virtue of its integration.
So if your comment is: is it right that BT should be investing in Openreach products to favour its retail business, differentiate them? Then I think we would say that is not the general model of regulation we have here.
Q. I think I understand what you are saying. Insofar as BT is investing upstream to create a differentiated retail product open to all, that is good. And insofar as it is investing downstream in relation to creating differentiated product for BT, that is also good?
A. Yes.
Q. And profitable revenue growth, is that good if it is based on investment and differentiation?
A. Often it is. But as a general observation, this is about what the VULA price should be, and to the extent you are achieving that through manipulating the VULA price that is a different matter.

Q. But in principle there would be a benefit to the firm and to consumers even if there is harm to their rivals, that is correct, isn't it? If you have a differentiated product, it may be slightly more expensive but it is a better product and the firm will benefit and consumers will benefit, that is correct, isn't it?
A. I'm sorry, you are going to have to spell out the scenario more clearly.
Q. I think Apple can probably take it. When Apple puts out the iPhone or the iPad, that is an expensive product, it's a product with investment and branding and everyone benefits, Apple makes a lot more money and consumers get something they want.
A. Yes, so when firms compete at the retail level by cutting their prices, investing in differentiation et cetera, that certainly can be very beneficial for consumers and that is what we like to see.
Q. And that is not a margin squeeze strategy in any shape or form, is it?
A. It could be part of it, because the problem we have in the margin squeeze is, yes, we would love -- we do like to see BT Consumer competing aggressively in the superfast segment and across broadband overall. But the problem obviously in the vertically integrated situation we have is that is only half the story. The problem is BT Consumer has -- it may go out there and think, yes, I have got to invest in sports rights and other things to drive my sales, that side of the ledger is very good. But by exactly the same token it may also think, well, over here I have got my VULA price that my rivals depend on, and as well as investing in sports rights I might be better off if I used that lever to undermine the effectiveness of rivals to compete.
Indeed, part of the concern would be that if they do that, that will actually undermine BT Consumer's incentive to do the good things we want because it will have a different and possibly cheaper weapon to achieve a stronger retail market position by undermining rivals' ability to compete rather than itself cutting prices and investing in good things.
Q. Yes. I think again you are saying there are some ambiguous features here. But you yourself, as it were, looked behind the curtain to some degree by appending some strategic documents as an annex to your witness statement. That is at tab 13.
A. Yes.
Q. You quote a number of items in this area of investment and differentiation. So, for example, at 2 you say -- I should perhaps say this is confidential so I had better proceed with caution. Item 2 relates to sports investments. Item 3 towards the bottom raises issues of differentiation, do you see that?
A. Yes.

Q. Then item 4, and in particular the long-ish paragraph, the second half of that.
A. Yes.
Q. And 10, another reference in relation to sports, fibre and differentiation.
A. Yes.
Q. 11, you see the strategy in relation to growth?
A. Yes.
Q. At 14, the focus of BT. I don't think that is confidential, there is profitable revenue growth.
A. Yes.
Q. Likewise at 18. In fact throughout 18.
A. There are a lot of themes on this, because the purpose of this annex was to show that BT does see significant focus on differentiating its broadband business.
Q. Yes --
A. In particular using fibre as a mechanism for that.
Q. These are not legal submissions, these are -- this is BT speaking to itself. If I could summarise it, it appears to be exactly the strategy I have described: investment upstream, investment downstream, differentiation and profitable revenue growth. You have exhibited this?
A. Yes.
Q. So does Ofcom have any problems with any of those strategies or objectives?
A. No. On the contrary, what is described there in many respects, as I said earlier, is BT Consumer looking for -- looking to differentiate itself, to grow, and it has been very innovative in the way it has done that.
Q. And it grows profitably?
A. Well here, if you are asking me does this imply that they did not have incentives to price squeeze? Then no, I wouldn't, because what this doesn't cover is incentives in relation to the VULA price, this is talking about their retail business's priorities.
Q. Yes. You're an economist rather than a lawyer but I suspect you are aware that the courts in relation to abusive pricing have basically looked at strategic issues and they have looked at costs issues, and so far as strategic issues goes, this looks like a policy of investment, differentiation and profitable revenue growth at the retail level, is that correct?
A. Yes, that is exactly how I see it.
Q. Can we now look at the market shares analysis and it appears in two places. First of all at paragraphs 3.55 of the final statement.
A. Can you remind me which one that is?

Q. Bundle III/I, tab 1. And it's page 30, it runs on, it is quite a long paragraph, 29 through 31. I'm not sure what bundles you have open, but also in your statement you address it in section D, figure 4 of your statement, and it may be helpful to have both. Page 20?
A. Yes, I have it.
Q. I'm not sure it positively says this, but am I right in thinking the graph and the figures in 3.55 should reconcile to one another? I am assuming they do. You were the economic director and this is the statement?
A. Can I just read 3.55. (Pause) Figure 4 in my statement is essentially based on the forecasts of CPs --
Q. Yes.
A. -- that we got, I think it was October 2014.
Q. Yes.
A. Off the top of my head -- sorry, it may be in the footnote references I just can't recall precisely whether --
Q. Again this was meant to be just to sort of clear the ground. What I was really getting at was the first bullet point you give various figures, on page 30, and then over the page you give various other figures at the last bullet point, the third bullet point. And they look to, broadly speaking, correspond to the end of the continuous line in your graph and the end of the dotted line in your graph. Does that seem right to you?
A. Broadly speaking, I just think it may be that some of the figures in 3.55 will be not precisely the same set of forecasts as these, that is all.
Q. Yes, what you see from the graph, it's quite vivid, isn't it, is a movement between 2008 and 2010 between Virgin and BT but presumably until 2008 Virgin had this part of the market pretty much to itself. Then there was a quite rapid change between 2008 and 2010, and then a more gradual process from then which is projected to go through to about 2017 as between Virgin and BT?
A. Yes.
Q. That is what one sees there?
A. Yes.
Q. Presumably that is -- as the VULA footprint expands, the effect is to bring the two together. And I take it that within Virgin areas, if I can put it, the graph would look very different. Virgin would still have upwards of 75 per cent in many of its own areas, is that right?
A. Yes, I don't have the figures for the Virgin areas but clearly, since they only cover less than half the country, these figures would translate into a substantially higher Virgin share in

the Virgin areas.
Q. I had thought it was a very easy calculation but the more I tried to do it, I found it wasn't so easy. But broadly speaking, it seems to equate to Virgin having market shares of between 70 and 85 per cent in the areas where it's present?
A. In terms of the roll-out, though, my understanding is most of the roll-out is close to complete. There are still areas where they are rolling out. So I don't think -- I'm not sure if the growth later down the line is likely to be significantly influenced by roll-out particularly.
Q. Roll-out of VULA?
A. Yes. I may be wrong but --
Q. I think that is more sort of filling up the can, if I can put it that way?
A. My understanding is they cover about 90 per cent of households now.
Q. Yes. Can we look at footnote 117 on page 31. It's a footnote to the statement which appears at the end of 3.55, that is not a confidential statement or confidential footnote, and it says:

> "The forecast data thus suggests that operators are predicting that the retail supply of superfast broadband would be more concentrated than has historically been the case for broadband."

Then it says:

> "To illustrate, the HHI index, which provides an indicator of the degree of market concentration on a scale of 0 to 1 ..."

I think it is sometimes done in thousands but here you have done it in 0 to 1:

> "... of the superfast broadband segment could be approximately 0.32 in 2016/17 based on the individual forecast data of BT, Virgin, TalkTalk, Sky and EE."

Then you say it hasn't included the smaller CPs.

And then it says:

> "This compares to an HHI of approximately 0.22 for all broadband subscribers in Q2, 2014 which suggests an expected increase in concentration."

Do you see that?
A. Yes.
Q. Can I just ask you about HHI or the indexes of this kind. I think they are taken as changes in concentration or a proxy for lack of competitiveness of a market or changes in the competitiveness of a market, is that right?
A. The way I think of them, and I don't think it is really necessary to put an HHI in, I just think of them as a particular metric for describing shares in markets. Personally, and I didn't write this particular footnote, but personally I prefer just to see what the shares are. It's just

simpler that way, to look at them.

Q. Yes, but since it is in the decision and you are the economic director then I think I am entitled to ask you about it.

A. You are. All I am saying is that would correspond presumably to the fact that the shares we observe in figure 4 look like a more concentrated structure of shares than is the case for all broadband which is plainly the case.

Q. Yes, but for the index you need to compare like-with-like, don't you? There is no point in comparing an index for sausages with an index for pork pies, it wouldn't make any sense.

A. Sorry, so when you are thinking of an HHI calculation?

Q. Yes.

A. Yes, I would agree. Market shares and their distribution, they give you a picture of what is going on in the market, they are not in themselves determinative of how competition in that marketplace is operating. So I have a set of shares for pork pies, and what was the other one, sausages --

Q. It's not a particularly good example. I think it would be better to have a subset, but there you go.

A. I would not, for example -- it wouldn't necessarily be the case, just because I observed slightly different shares for sausages and pork pies, that that necessarily corresponded to a difference in competition. What I would have to do is look at sausages and pork pies and make my decision and I probably would move past the HHI fairly quickly.

Q. It was an unfortunate example, but anyway, all I am putting to you is it needs to be on a properly defined market for it to have any real significance, would you accept that?

A. Shares are simply a record of who is making sales of a particular market or product.

Q. In particular, if you had shares on a submarket, that could give distorted results. So again, a sort of colloquial example, I can recall the Renault Espace being launched and perhaps being the leading vehicle but it might have given a distorted picture if you compared that to the total car market. And that is particularly true where you have a new market segment, is that not the case? If you compared the one with the other, that wouldn't give a very clear picture?

A. So clearly figure 4 gives a picture of who is doing well in selling superfast broadband retail products, and the overall share of who is doing well selling broadband will look somewhat different than that figure because this is a segment of the market, not the whole market.

Q. Yes, and that was the point I was going to put to you. That is what Ofcom found in the Wholesale Broadband Access Market Review. It looked at it again in FAMR, it looked at it again for the purposes of this decision, and in each case it found it was a single market for broadband.

A. I agree. If the question is essentially does the picture of shares in superfast broadband tell us -- give us a complete picture of how strong BT Retail's position is either in the market overall or -- then clearly it doesn't.

Q. Yes. We have talked about this, this is a premium product, BT has launched it as Infinity, Virgin has their VIVID brand, so it's a submarket.

But anyway, footnote 7 says there is an expected increase in concentration. Do you see that?

A. Is that 117?

Q. Footnote 117.

A. Yes.

Q. That is based on a comparison between the HHI of all broadband in Q2, 2014, as against the projected HHI for superfast in 2017. That is the basis for it, isn't it?

A. Yes, that is fair.

Q. That is what I -- perhaps sausages and pork pies is a bad example, but it is a subsegment compared to a full market, isn't it, so it doesn't really make much sense?

A. I think it is a useful metric for two reasons: firstly, it is a subsegment, but it is a differentiated subsegment, so it is well known that where you have differentiated products, there may be closer competition within that segment than the shares of the overall market might suggest.

I think more importantly for me, this is not just a subsegment, this is really the future, and what we are looking at here is essentially how competition is playing out in a segment that, well, as I say in my reports, in principle it may become a separate market at some point in the future, but that is not really critical because even if it doesn't, what is going to happen is this segment is going to emerge as the preponderance form of broadband in the not too distance time.

So while these shares don't tell you how broadband overall is going to develop in terms of overall shares, this picture, if it continued, would inevitably, if you were to have a graph of what the shares of all broadband looked like, and those dotted lines continued at the sort of level they are at in sort of 2016/17, what that is going to point to is BT gaining a very substantially larger overall share in broadband than it has at the moment.

Q. Can we look at the superfast broadband position in slightly more detail, and again we have tabulated your information which I hope is a useful format, so if I could hand that up as well?

THE CHAIRMAN: Would that be a convenient moment to have a five-minute break?

MR. THOMPSON: Yes, sir. I will hand this out. (Handed)

(11.45 am)

(A short break)

(11.50 am)

MR. THOMPSON: Mr. Matthew, what we have done in these two little documents is first of all taken the figures in the first bullet point on page 30 and the third bullet point going over onto 31 and merged them with your graph as best we can. That gives actual shares at the end of your continuous line in the left-hand column of the documents, actual and forecasted shares of SFBB connections, do you see that?

A. Yes.

Q. And I think some of them are confidential but I will -- or have not been stated in the document, but Virgin and BT at 51 and 37 is stated in the published version. And then there is an accumulative sum for Sky, TalkTalk and the third operator whose identity -- I'm not sure whether it's still confidential but I will keep it confidential. Then there are projected shares which, again, I think those are treated as confidential in the documents so I won't state them but you will see the movements of those shares.

Then in the separate document, we have followed through the logic of footnote 117, and done what seems to have been the HHI calculation that appears in footnote 117 although the figure we reach in the bottom right-hand corner is slightly higher than the figure that appears in the document but I think that is because of some either rounding effects or because of the discounting of the smaller operators because if you just take the larger operators it comes to roughly that figure. And then we compared it to the position at the latest actual date that appears in the first bullet point on page 30.

Since they are taken from your own decision in your own evidence, I am assuming that you will accept these figures subject to the arithmetic that has been carried out in relation to the projected HHI figure for the current position or the position at October 2014. Do you understand what has been done and do you agree with it?

A. Yes, they look like the right sort of magnitudes.

Q. I think I can say this without breaching confidentiality, but you will see that the concentration ratio for the SFBB segment, insofar as that is a legitimate exercise at all, shows a marked decline on the projected figures reflecting primarily the decline in the projected share of Virgin and the increase in the projected shares of the smaller operators, is that right?

A. Yes, that is correct.

Q. And in particular the two principal protagonists in support of you are projected to see very substantial increases in their market share. Do you see that?
A. In -- yes, so their share is going up proportionately, yes.
Q. Very substantially.
A. You mean the fact that it's -- I won't give the figures, but you mean the share is ... for example, we might say for one of them the share for example doubles, whereas BT's does not.
Q. Exactly.
A. That sort of comparison, yes. You will tend to find that in a growing market anyway.
Q. Yes. I'm only going against footnote 117 which looks at presumably these same statistics and describes them as showing an increase in concentration, whereas in fact there is a marked decrease in concentration, isn't there?
A. Yes, I agree. And -- yes, so the structure of the shares is going to be the case that there is an increase for BT's competitors in their share. I just observe that in a growing market that might not translate into them actually winning more volumes than BT, it's just simple arithmetic of percentages.
Q. They are coming from a smaller base?
A. Exactly. So, yes, they start off with a very small percentage share, and then fairly modest increases in their volumes might lead to a really quite large jump in their percentage share, say from 2 to 6 or something, it is a trebling. That doesn't imply that they are actually winning more volumes than BT.
Q. No, but I think we have discussed already, and I think you have accepted as legitimate, that BT had made major investments, had a strategic focus on this area in response to Virgin's initiative, and branded itself, so you would expect it to do well in the first instance?
A. Yes, and these shares are, as we have said before, not reflective of an actual price squeeze.
Q. And the position -- we looked at the historical position with Mr. Clarkson, under the old regime, of TalkTalk and Sky's position between 2013 and 2015, showing very rapid increases, and we are now looking forwards and finding the same pattern, is that correct?
A. Well, we are seeing significant increases in the -- significant proportionate increases in the shares of BT's rivals, but that is not translating into a large share for those rivals.
Q. No. What I don't understand is either why you say there is an increase in concentration or why you say that there is a risk, which is how 3.55 starts. Because this looks like the smaller operators are now moving relatively rapidly into this new market segment, does it not?
A. As I said, I think the proportionate increase in the shares doesn't tell you that much given that

they are starting off from a very small base. The inference I drew from figure 4 is not that Sky and TalkTalk are unable to match BT's offers or that the picture we see there reflects a price squeeze in operation, I am merely observing that when we get to the end of this period, which is still some way off, and well after the period when some of the early reasons why they might not have concentrated on superfast as much as BT did, it is still not a very high share for them and it is not comparable to where they are in broadband.
It's not my view that this reflects a competition problem, for me this is very much just context, which tells me that if BT were to engage in anti-competitive conduct or implement a price squeeze, that is something we should be very mindful of and worry about because the picture doesn't look that strong compared to the way things have been in the past.
Q. That is not what the decision says. The decision says:

> "There is a risk that the future structure of the superfast broadband segment could be very different even in three years' time to what we observe today in broadband as a whole."

So you are seeing these projected figures as somehow risky, that they don't look right to you. But what I am saying is what they show is that the small competitors are increasing rapidly, doesn't it?
A. It shows their proportionate share is increasing. For us and for me, it shows this is a market environment where one should be concerned if there was the prospect of a price squeeze because their starting point does not look as healthy as things had been for standard broadband in the past, and that is the only point I would make on this.
Q. But we have looked at the expected increase in concentration point in footnote 117 and that is not right. Can we look at 35 --
A. Of my report?
Q. Yes, the previous page just before the graph. At the end you say:

> "On current projections by both BT and the other main competitors, the provisions of SFBB would appear to be closer to a duopoly by the end of the current review period."

When you look at the graph, that is just not right, is it? Because until 2012 it was a duopoly, whereas what appears is that it is no longer going to be a duopoly on the projected market shares. There is going to be quite significant growth and quite a significant competitive force from two very well-established competitors, namely, Sky and TalkTalk. That is what this shows, doesn't it?
A. Just to be clear, I wasn't suggesting it was a duopoly in the sense there would only be two

competitors. Clearly Sky and TalkTalk, including through these shares, will be -- are expected to be there competing. So there are not just two competitors, I was merely making an observation about the structure of shares as they would pan out at that time. That is all.
Q. When you say "closer", that is ambiguous. It is actually further away from a duopoly in one sense, isn't it?
A. You mean literally if I look at the position as it was in 2010 where -- well, no, I agree. So if one wants to look at the shares and ask yourself what shares do the top two providers account for? Which might be one way of measuring it, I would agree, that that -- yes, the words "closer to a duopoly" is a reference of relativities with other broadband I think, not with the past, where clearly at one point BT and Virgin were the only games in town.
Q. What I really understand, and it appears in various places in your statement, for example at 36 but I think also at 90, is that Ofcom seems to see some problem if the outcome in superfast broadband is not exactly the same as in standard broadband. That is what seems to be the underlying concern, that it ought to be the same. Is that right?
You say in 36:
"The SFBB segment is not developing as effectively as has been the case for retail broadband overall."
Then in 90 you say the same:
"Concerns that competition in the SFBB segment is not developing as effectively has been the case for retail broadband overall."
It looks as if the word processor has been at work there, but it's the same point.
So is there a sense in which Ofcom wishes to achieve an outcome of basically the same market structure for standard broadband as for superfast, is that really what is driving all this?
A. Absolutely not. We have no particular engineered market share outcome in mind and I think that is clear from the second sentence of 36. The inference I am drawing from it is not that we must have four equal shares otherwise we have a problem, I am observing that the structure of how superfast sales are panning out and are expected to pan out creates a context where one should be worried about price squeeze being implemented, which is not the point you put to me.
PROFESSOR MAYER: Can you just clarify that point a little bit more, Mr. Matthew, how we should relate the market structure as you see it emerging with the risk of a price squeeze, what is the relationship?
A. I think if we imagine a different world, say one where -- perhaps it is in time. Let's imagine a

world where Sky, TalkTalk, BT and Virgin were all very well established in superfast broadband at a period where that has become the predominant form of broadband, and you were to ask yourself what are the risks associated with a price squeeze? And there may still be issues there, in particular if you are relying on a retail minus price control it might be the case that you would want to control BT's pricing to avoid excessive pricing. But in terms of is there a price squeeze risk, you might say, well, that is probably going to be less of an immediate concern. The market is established, it is probably more about who makes money out of it, and the risk might be a bit different.

So I think the way I see it is, when you start off from a position well ahead of that being the outcome, you are in a position where BT would be looking at more than just how much money can I make out of VULA and, at the margin, can I get some more customers for BT Consumer? They may think, well, actually against this background Sky and TalkTalk are being very slow, their position isn't projected to get that strong very quickly but it is going to come, we would expect, although as they remain healthy competitors. But if we put in place a price squeeze now, we may lead -- if we take the extreme version of foreclosure, we may lead to a situation where one of them decides: actually, I really am going to give up on superfast broadband, I'm just not going to try, I am going to shift my commercial strategy to exploiting my copper assets and give up on the future.

So the pay-offs could be much larger and the impact could also be large because you would lose one of your competitors. So I think it is building on a situation that doesn't look as healthy as the one we have today in broadband, and the potential link goes back to if I pull the VULA lever am I going to get significant retail benefits? I would say arguably yes in this sort of context.

PROFESSOR MAYER: So you are saying that there may be greater benefit to BT in squeezing off competition in an embryonic market.

A. I think, yes, that is the way I put it. A greater foreclosure benefit, a greater prospect that they may seriously damage one of their rivals' ability to compete over time.

PROFESSOR MAYER: Thank you.

MR. THOMPSON: Can we just look again at your figure and see whether you do or don't agree this as a credible analogy for what has happened here. It looks like there was initial investment by Virgin Media and took a very substantial and relatively mature market share over a period of years of over 50 per cent of the market by means of its initial investment in superfast broadband, would you accept that?

A. Sorry, so on Virgin, yes, they started off with a very large share --

Q. And it is still over 50 per cent of the market as at the end of 2014.
A. Yes.
Q. I think you call it a closed system, which I think means that Ofcom hasn't intervened, despite those very high market shares, to require Virgin to share its investment with anyone else, that is what the closed system means?
A. I'm not sure I have heard the reference to closed system before, but, yes, Ofcom does not regulate access to Virgin.
Q. And then it looks as if BT reacted by investing itself and built up quite a strong market position, and we have had it described by Mr. Petter in the investment in Infinity et cetera, and that is what one sees as it were up to the end of the continuous line.
A. Yes. Yes, BT has certainly pushed fibre much harder and much earlier than its competitors on using VULA, and itself engaged in a bit of catch up against Virgin. Because of the technology of their network, they essentially upgraded most of their customer base very quickly.
Q. There is evidence which -- it is not intended as criticism but it is a fact I think, that Sky and TalkTalk haven't made such investments, and there are obviously reasons, commercial reasons, why they haven't done that, but they have invested quite heavily in LLU, and they have been given quite a significant regulatory benefit in relation to LLU, and we discussed that with Mr. Clarkson.
A. I would agree that there are a variety of reasons why Sky and TalkTalk have been slower than BT to get going on fibre. My understanding is they have been pushing it fairly hard for a while now and, as this graph shows, they do expect to get gains in their fibre subscribers over time, although not to the point where they are going to reach a scale of BT's size in the next few years.
Q. But they haven't invested in the hard wires, as it were, or the fibre?
A. No.
Q. And they haven't invested in the branding. Their unique selling point is not high speed broadband, that is Virgin's particular selling point and, more recently, BT's with its Infinity brand. That is the position, isn't it?
A. Certainly Sky and TalkTalk have not yet built their own network, which I think was your first point. They are now, as I understand it, marketing fibre products more prominently than they used to.
Q. Yes, I think Sky has made a large offer for free fibre for a year, I believe.
A. Yes.

Q. But that narrative of Virgin then BT and then the others makes perfect sense and is a perfectly normal evolution of a new market segment, is it not?
A. But as I say, we are not saying that the projections we see here are themselves the result of price squeeze or anti-competitive conduct by BT. So, yes, this presumes, I think, that Sky and TalkTalk will perceive themselves able to match the BT offers and over time they will upgrade their bases to use fibre.
Q. Yes.
Can I move to another topic, which is the types of margin squeeze with which Ofcom may be concerned, and there are broadly three -- sorry, I am just reminded the word "closed network" is actually used in the statement at paragraph 3.61 in relation to Virgin but I don't think that is -- I think Mr. Holmes used a similar expression, but I don't think anything turns on that.
Broadly speaking, there are three types of margin squeeze if I can put it to you like this. First of all, there can be excessive pricing on the upstream market, squeezing margins downstream, and I think that is one of the concerns you have expressed and Mr. Clarkson has expressed. Secondly, there can be discrimination upstream whereby the monopolist or significantly dominant firm actually treats its downstream arm better than the rival purchasers. And thirdly, there can be predation on the downstream market. So a powerful retailer can pull down its prices with a view to driving competitors out and that is, as it were, predatory pricing on a vertically integrated market.
Would you accept there are those three possibilities, in outline terms?
A. There may be others. So your first is someone may price squeeze just by setting a high price for the wholesale products.
Q. Yes.
A. Your second is they may discriminate. I'm sure that can be part of it. I think generally in price squeeze we are talking about a transfer price, so I'm not quite sure that discriminatory pricing as between your own retail division and your rivals' carries significance on its own because for your own retail price you would largely ignore it --
Q. That could in principle happen. You could target your rivals and charge them more than you charge your downstream arm?
A. Yes. I think my point is simply suppose I set the same price for my own downstream division as I do for my rivals, that doesn't stop me from still setting a high transfer price because my downstream provision doesn't care because it just says, okay, my accounting profits downstream have reduced but my upstream profits have increased so it all nets out.

So you might do it that way, or you might say, okay, I will set my own price to my own downstream division at 5 and I'll set the price of 10 to my rivals, you might do it that way. But the relevant question is do you set the price at 10 for the rivals, not what you are doing for yourself?
Q. But in principle, if everyone is charged 10 and the retail price is also 10, then that is an excessive pricing margin squeeze. Whereas if the price to your downstream arm is 5 and 10 to everyone else, that is what I am calling a discriminatory pricing squeeze. In broad terms I think you could accept that?
A. Those are just differences in the magnitudes. You could have a price of 10 -- you could have a wholesale price of 10 and a retail price of 10 and that would still be a price squeeze if that margin, which would be zero, is not sufficient to cover your retail costs.
Q. Just --
A. So you don't need to set a higher price for the wholesale price than your own retail prices to achieve a foreclosing margin squeeze.
Q. No, no. Indeed. I'm just trying to focus on what it is that we are worried about here. As I am understanding it, I think it was reflected in the way Mr. Holmes opened the case and it's also reflected in the terms of the final statement, the focus here is on upstream pricing, excessive pricing or possibly discrimination on the upstream market, and there is a good reason for that in that BT doesn't have SMP on the retail market, it hasn't been found to have it which is actually under a different legal regime under a different directive, so Ofcom would have jurisdictional problems about, for example, setting a floor on BT's retail prices. That wouldn't be within its powers because there is no finding of SMP on the retail market, is there?
A. I don't know about that. Sorry --
MR. HOLMES: Sir, again this is a legal question.
A. My point is what we are concerned with here is a price squeeze condition. So the relevant question is would they raise the VULA price to a level where the resulting margin between the VULA price and their downstream retail prices was not sufficient to cover retail costs?
MR. THOMPSON: That is the focus of your concern.
A. Yes.
Q. And I don't know whether -- did you have any dealings in relation to the Commission's concerns expressed in their letter?
A. Yes.
Q. Can we just look at that briefly then. It's at tab 9 of core bundle III/II. It's towards the end,

after the Commission has expressed its concerns about the design and the lack of flexibility in relation to the six-month, at that point, period for recovery of costs. At the bottom of 6, the Commission says this:

> "Ofcom's purpose in designing the test is to address a competitive concern in relation to pricing of the regulated product, i.e. VULA, for which it doesn't propose a charge control. However, the design of the test proposed by Ofcom may result in BT choosing to address a failed test by changing its behaviour on a market other than the regulated market, for example by increasing retail prices or reducing costs for BT Sports. Given the magnitude of the costs involved and the uncertainty of future costs and revenues of BT Sport as new rights auctions approach, there is a risk that Ofcom's regulatory intervention would have a significant impact on non-regulated markets without necessarily affecting the price of the VULA input. Ofcom will therefore have to remain vigilant that the application of the test doesn't have unintended consequences in markets where the application of ex post competition law would be sufficient or where BT's SMP in the WLA market does not necessarily play a role."

That is the point I have been making to you, that you wouldn't have jurisdiction, and as a matter of economics it would be wrong for you to try to constrain BT's competitive position on the retail market where it hasn't been found to have SMP. That is what the Commission is saying, isn't it?

A. I think the Commission here is commenting on the way BT Sport costs should be treated in the VULA margin conditions, isn't it?

Q. No, I don't think it is doing that. I think it is saying Ofcom can't try to meddle in the retail market because there is no SMP and it is not even part of the right jurisdiction.

MR. HOLMES: Sir, the way this question is being put contains a legal element on which this witness cannot comment. Questions of jurisdiction are for submission, they are not for putting to an expert witness.

THE CHAIRMAN: I do agree, Mr. Thompson. I'm not sure it really helps to get Mr. Matthew's views on this letter.

MR. THOMPSON: Let's come to your statement and see what it is you were worrying about. I had understood you were either looking for a -- I think I described it as a bear in the woods, either a discrimination or an excessive pricing problem. That seemed to be the tenor of what you were worried about in relation to the VULA price, that seemed to be the tenor of the statement. In particular, there are repeated references to BT setting a VULA

price which favours its retail business and one finds that for example at 13B.
A. This is my statement?
Q. Yes, your statement, page 5. You can put away the Commission's letter now.
A. 13B?
Q. Yes. You say:

> "BT will have incentive to set the VULA price to favour its retail business ..."

That is a repeated theme. I can give a number of references, for example at paragraph 22 you say the same thing, paragraph 86 --
A. Yes, I haven't checked all of those, but it is a theme, yes.
Q. If we look in 22 we see in the third and fourth lines:

> "BT should not be able to use its control of the critical wholesale inputs to favour its downstream retail operations."

And you say the same in 22E:

> "Allowing a price squeeze could exacerbate the risk perceived by BT's competitors that BT was free to use its vertical integration to favour its retail business."

And then at 22C, do you remember this, you talk about setting a price to negate advantages of its rivals, do you see that?
A. Yes.
Q. Presumably that could only work if you somehow damaged them by giving them -- harming them by the VULA price to them as against the VULA price to BT Consumer, you must be, as it were, favouring BT Consumer again otherwise it wouldn't negate the advantage, is that right?
A. Yes, I think so.
Q. So there seem to be allegations of discrimination of raising competitors' costs while keeping BT's charges constant, is that right? Is that what you are alleging here?
A. Yes, effectively. I think 22C is essentially a theme that is in my report about the nature of the concerns that can arise with a price squeeze, so we have I think the sort of standards -- sort of outright foreclosure concern which is where BT sets a very low margin for a period that seriously undermines rivals' ability to win customers, they become much smaller, potentially exit the market, and BT can benefit from that.
What I am trying to do here is outline that actually that is not the whole story because perhaps a more moderated version of that arises where, okay, let's suppose there is a situation where BT's rivals are selling to customers who wouldn't switch to BT as a

consequence of the price squeeze, but nevertheless when those rivals are thinking about should I make investments in terms of the services I am offering or offer them low prices to induce them to buy my better fibre product, they will think -- they will have an eye on the future and say, well, this might be a good thing for me to do today, but what if the VULA price is jacked up to me in two years' time after I have made those investments?

You can quite quickly see that in a situation -- clearly there is an important element of retail competition, but you can quite quickly see that in that situation effectively you are saying to BT's competitors, look, you need to make investments in competing with BT Consumer, and even if you have got some advantages of your own that allow you to stay in the battle, you are exposed to effectively a drip-feed risk of expropriation of the moves you make, and that's going to reduce their incentives to compete dynamically in acquiring customers et cetera.

So even though they may still be there in three years' time, may still be important companies, the way in which they compete and the intensity of it is likely to diminish if they feel they are exposed in that way.

Q. It sounds like in a similar sort of area to some of your earlier remarks where I said it didn't sound much like a margin squeeze. You seem to be taking a pretty broad approach to the concept of a margin squeeze.

A. Well --

Q. I am slightly -- at the moment I was just asking you, and I think you agreed, that all these references to favouring BT's retail arm sounds like a case of discrimination, in my terms, and I think you agree with that?

A. I just don't necessarily find discrimination a useful concept here. It is about do they set a margin that allows rivals to match their offers, covering retail costs?

Q. But the repeated references to favouring BT's retail arm does sound like a classic case of discrimination.

A. Well, as I said, I'm not sure I see discrimination as the right word. What I am thinking of is when they choose to set their retail and wholesale prices they will take into account the effect that has on their retail business and that will lead them to set a higher VULA price relative to retail prices than would be the case if they didn't have that incentive.

PROFESSOR MAYER: Just to clarify this, your argument to me does not seem to hinge on saying they would charge different prices to competitors from that which is being charged to BT Retail.

A. That is absolutely correct.

MR. THOMPSON: Just to close this out, I think it was said by Ofcom's counsel in opening, and particularly in cross-examination of Mr. Petter, that discrimination couldn't be a form of margin squeeze but I think we have agreed that it could be, and I think you also agree with me, with the qualification you gave, that all these references to favouring BT's retail arm do sound like an allegation of discrimination?
A. As I said, I just don't find discrimination a useful -- I prefer the way I just spelt it out.
Q. Given the indications I have had from the Tribunal and the protests I have had from Mr. Holmes, I won't push it any further, but your position as an Ofcom official includes the obligation to take account of guidance from the European authorities, and I think you were probably here when Mr. Holmes read out that discrimination and excessive pricing are both recognised forms of margin squeeze.
What I will go on to say is that insofar as the element of discrimination was part of your reasoning, then I think you would accept that that was a central focus of the undertakings that were given by BT back in 2005, would you accept that?
A. First you are going to have to spell out what you mean by discrimination because I am struggling with what you mean by it in concrete terms. Secondly, and perhaps to cut this off, I'm not an expert on the undertakings of 2005.
Q. No. I will just give you the indication of what it is I am talking about and I will take it as quickly as I may.
The undertakings document is at --
MR. HOLMES: Sir, given that the witness has just indicated he is not familiar with the undertakings, I'm not sure what value Mr. Thompson hopes to extract in terms of useful evidence for the Tribunal by showing him a document which can be shown in submission.
THE CHAIRMAN: I tend to agree, Mr. Thompson.
MR. THOMPSON: I will move on.
THE CHAIRMAN: How are we doing in terms of timing?
MR. THOMPSON: We are going a bit more slowly than I had anticipated. I don't think I am going to quite finish this morning.
THE CHAIRMAN: An early finish?
MR. THOMPSON: I hope so, yes. I was going to look at the issue now of what exactly the positive case is that Mr. Matthew puts forward.
THE CHAIRMAN: Very well.
MR. THOMPSON: In my submission your real case -- my submission, I will put it to you whether you agree with me or not, is that the core concern you have here is in effect a form

of excessive pricing margin squeeze of BT pushing up the VULA price and constraining competition on the downstream market, is that correct? I think you have been reluctant to accept the characterisation of discrimination so what seems to be left is an inflated VULA price constraining competition downstream, is that right?

A. Yes, I think it is fair to say -- I'm not quite sure I would put it in precisely those terms, but yes, essentially the concern is that BT would raise the VULA price to a level that, relative to its retail prices, wouldn't allow a similarly efficient rival to cover its retail costs.

Q. But if BT simply put up its prices to the profit maximising price, would that be a concern in itself?

A. Not here, because we have agreed BT should have pricing flexibility in respect of VULA in the sense that it's allowed to set a higher price at profit maximising levels because it is not regulated under cost plus terms. But of course it would need to do that -- at the same time as doing that it would still need to have its retail prices set at a margin above that that allowed retail costs to be recovered.

Q. Yes. I am just trying to get to grips with what exactly it is that you are worried about and I think we have had some indication from the exchanges we've had already so I'll try and take it reasonably promptly. But you will be familiar with the fact that the regulation of excessive pricing was partly dealt with by the FRAND condition and partly was considered, as you have said, in FAMR where it was decided not to impose a charge control, and I debated some of the reasons for that with Mr. Clarkson. You remember the constraints from standard broadband, the risk of error, and the effect on investment incentives, you remember all that?

A. Yes.

Q. Then at paragraph 22 you set out a number of concerns. I think in 22A and B in particular, the initial wording does describe a conventional margin squeeze. So first of all:

> "Foreclosure in the sense that BT's competitors are unable to match BT's prices in the short-run leading to a reduction in short- or long-run retail market competition and setting a high VULA price that excluded rivals from competing for SFBB for a period."

So those sound like conventional margin squeeze cases. But then you say:

> "In the extreme case ..."

Which makes one doubt whether you actually think either of those possibilities is actually realistic. So is that right, that Ofcom is not really talking about those sort of core exclusionary cases?

A. The reference to "In the extreme case" is to A, not B.
Q. Yes, exactly.
A. And it's talking in the context of classical foreclosure. I think the point I am making is that the extreme case of foreclosure is that the rival completely gives up on the market and ceases to be as an effective competitor entirely, outright exit. So that is the extreme case. Obviously there are gradations before you get to that point which is where the rival's ability to compete in the future is damaged, such that the intensity of competition diminishes but the rival need not exit completely for that to be the outcome.
Q. By the end of A, you have gone to even a modest weakening of competition, and that is really quite a different concern and I would say that is not a margin squeeze at all, that is just competition. The problem with your statement is I find it very difficult to distinguish the one from the other. But would you say a modest weakening of competition is still a margin squeeze?
A. Well, if a price squeeze would result in a modest weakening of competition then, as I say, that is liable to adversely affect consumers over time.
Q. Look at 22D. You say:

> "There is a risk that BT might raise the VULA price to expropriate the profitability associated with these investments."

So that is where there has been an investment.
There are two possibilities, aren't there, that BT might just put its price up as part of a commercial negotiation taking account of the overall profitability of this market, and there might be some toing and froing and the price might be a bit higher than the downstream competitor would like, but is that really a margin squeeze or is that just ordinary commercial negotiation? How does this tell the difference between the two?
A. This is saying that if you allow BT to price VULA freely without a price squeeze condition, this is the sort of thing that it might do, or at least competitors might perceive that it might do, and this is one particular way in which that could result in a reduction in future competition.
Essentially this is the further theme on if you don't allow competition on the merits and you expose people to this sort of risk, their incentives to do things where it requires investments will diminish and that could be quite harmful.
Q. Let's see how low it goes, because at the bottom in 22E you raise the possibility:

> "Even in circumstances where BT doesn't actually impose a price squeeze, the threat that it might do so in the event that retail rivals emerge as stronger

competitors could itself dampen the incentives for a rival to compete as strongly."

Is that within your concept of a margin squeeze? Something expressly not a margin squeeze but a competitor might think that there might be a margin squeeze. Is that within your concept of a margin squeeze?

A. It is clearly relevant to whether one should have a regulatory intervention to say you cannot margin squeeze. Because what is being suggested here is -- leaving aside what BT actually would do if the competitor perceives that they might do it, in particular raise the VULA price to it after it has made some investments in growing its business, that would disincentivise it from doing just that, and that can arise even if BT hasn't actually price squeezed. The mere threat of it could be the problem. I think this point -- I think it is in Sky's submissions.

Q. It may well be. That is quite interesting, actually. The original consultation wasn't going to introduce this regulation and then I think Mr. Clarkson said Sky and TalkTalk came along and said that is not good enough. Then you changed your position. But can it really be the case that if, for example, Mr. Heaney or Mr. Blumberg come along and say: I am very worried about BT engaging in a margin squeeze, that is enough for Ofcom to impose a condition? Can it really be enough that the competitors think that BT might impose a margin squeeze? Is that really enough?

A. Firstly, it is one of a list of factors I'm pointing out here. I am just merely pointing out that is a further one. Sky's argument, if I remember rightly in their statement of intervention, essentially is on this theme. I think it was put to us during the process. So essentially they were saying: look, if we don't have reasonable confidence that we are not going to be exposed to ratcheting up the VULA price after we have upgraded our base, then that will lead us to have lower incentives to do that. That makes economic sense to me.

Q. But would you accept that is a very low test, and it is not just theoretical because it is actually -- I think it is a passage Mr. Holmes didn't refer to but it is actually in the final statement at 3.92, on page 43.

A. Yes, that is essentially the same point.

Q. It is. It says:

> "Even if BT doesn't actually use any latitude to set a low VULA margin, the threat that it might do that in the future could undermine rivals' incentives to expand as strongly in superfast broadband."

But, in my terms, that is like a ghost of a margin squeeze. So, even if there isn't really one,

it is good enough if there might be one. Do you go that far?
A. I think this is -- I just return to my previous statements. If it is the case that there are no controls on BT's ability to raise the VULA price, the price squeeze condition being one of those, whether it's in the form we eventually ended up with or the variant of FRAND with guidance, this is one of the negative effects you might get. And I don't see that that is a problematic point.
Q. Is that really consistent with the very first -- where we started, the bias against regulation and the need for evidence, that it can be good enough if people come along and say: I am very worried about this, and so effectively that is good enough? Can that really be enough?
A. Is the suggestion that: imagine all of the other evidence made it absolutely clear that BT was never going to introduce a price squeeze, would it then be sensible to introduce a regulation that stopped them from doing something that they say they are never going to do because competitors were uncertain? One would need to think about that. Clearly, there are other things going on here and I suppose, as a matter of sort of logic, if BT was never going to do this, then committing not to do it wouldn't harm BT. It would, nevertheless, give certainty to its rivals, which is what they want.
Q. Yes, I know they want it, but it's a different question. We have seen that, under the old regime, they were thriving. Under the old regime, if it carried on, they are projected to thrive. But if they come along and say: we are very worried about this. You say: okay, we will give them a bit more regulation. That seems to be what you saying?
A. No, I am saying we think there are other reasons why BT might price squeeze, not just this. So it's not clear that BT wouldn't do it as a matter of position. So it's a somewhat academic question to ask yourself: what would you do if it was clear that all the evidence showed that they wouldn't price squeeze, which is not the case before us. But ultimately, if the outcome is that rivals actually would be precluded from expanding and investing in their businesses because they lacked certainty in relation to the VULA price, then you would want to take that into account in deciding what you should do about it.
Q. Can we go finally at 22F on page 12. You say:

> "A price squeeze may reduce or eliminate competitors' ability or incentives to offer effective competition to BT even where there is no exclusionary intent on BT's part."

Then there is a reference to the issues we have been discussing about the early lead. Then you say:

> "Even if that is the reason for imposing a price squeeze, the effect may still be

> that BT retains a strong retail position and its competitors' ability or incentives to compete in the long-run are reduced."

I think this brings it to a focus. Because the words "imposing a price squeeze" could easily be replaced by "competing vigorously on price" and the whole thing would just be the same. How do you distinguish here between BT competing vigorously on price? Because this whole thing would go through on the same basis. What is it you are actually talking about here?

A. You put your finger on the problem, which is BT has two levers here; it can compete by setting low prices, investing in its products, the good side of competition on the merits if you will. But it also has control over a key input for rivals, and what the price squeeze condition is doing is it's saying: well, it might be the case that you are competing aggressively for good reasons, but it might also be the case that you are setting a high VULA price for whether it's even intentionally bad reasons or simply because they find that very profitable.

The reality is you have two levers in front of you and one of them is potentially damaging to competition, and what this is all about is ensuring that isn't used to favour the BT Retail business.

In terms of outcomes in any case, if this question is about whether incentives to impose a price squeeze in an effort to foreclose are relevant, then I think that is relevant to the foreclosure arguments, but that is only one source of potential problem. So leaving aside precisely why BT might impose a price squeeze, if they actually do, that will still undermine competitors' ability to compete on the merits.

Q. In the course of your answer, and we can obviously check it with the transcript, I think you have used the expression to which we have taken exception in various places that it doesn't prove that BT wouldn't impose a price squeeze. It does appear that, at least on occasion, you seem to place the onus on BT to disprove the existence of the risk. Do you go that far?

A. No. Sorry, this is a reference to not quantifying with precision what I think the BT incentives might be, which is a point that is made in various of the submissions.

Q. I think it is more than that. There is a narrative of why Virgin has done this, BT has done that, Sky and TalkTalk have focused on LLU, and that is quite a clear story, the branding issues, the points you have accepted. But then we seem to shift to BT might impose a price squeeze and it hasn't proved that it won't. You do appear to put the onus on to BT to disprove that in some way, and it's difficult to see how BT could do that and how that could be the basis for your decision.

A. That is not how I characterise it. I think we have put together appropriate evidence to conclude there is a real and significant risk that BT would impose a price squeeze if it were free to do so. That is the position I set out in my statement. Not that there is some sort of academic risk in BT's job to prove that they would never do it. I think the evidence shows that there is a risk of that. It might be that BT could have put together -- they might have responded to the points we made in the final statement in here with evidence themselves. If they really felt that things like diversion to Virgin or losses to Openreach were likely to be so large that it really ruled out that finding that there is a real and significant risk, they might have advanced that. But that is not saying the onus is on them to disprove it. The onus is on us to show there is a real and significant risk and that is what we did.
Q. I think these issues have probably been fairly well aired, but in principle I think you would accept that the raising of the VULA margin could certainly lead to diversion of volumes away from VULA and BT to Virgin, and so there is a balance that would have to be taken into account by BT.
A. I think you said the VULA margin. I think you meant the VULA price.
Q. Yes. I guess that is right, yes.
A. Yes, I would agree. If BT raises the VULA price to Sky or TalkTalk and the consequence is they pass that on in terms of higher prices, as you have laid out and as we previously laid out, there is a variety of places those customers might go. They might go back to standard broadband, they might go to BT Retail and some might go to Virgin. That would -- you throw that into the mix if you were to try and undertake a precise quantification of how all this would exactly pan out.
We have seen from Mr. Heaney's statement that probably the Virgin effect might not be that large and, while Virgin is an important competitor here, obviously that diversion would only cover half the country. Looking at things -- if you look at Virgin's market shares over time, and they don't tend to be the biggest movers, you tend to see a lot more sort of shifting around within the Openreach network. So it may be the case there is perhaps less switching with Virgin than there is within the Openreach environment.
But I would agree that that would be one source of loss to BT Openreach. I would also note that, when somebody does spin off from Sky and TalkTalk to Virgin, they would lose, not just the potential fibre wholesale revenue, they would also lose the other charges as well. So, all else equal, BT doesn't like losing customers from Sky to Virgin.
Q. Yes. And equally, and I think it is a point that Mr. Bishop made quite eloquently, is that, even on these projections about the expansion of superfast broadband, there will still be a large

field to play for of approximately half the market, which will either be on no broadband or standard broadband going forwards. So if the VULA product is priced too high and the margin effects between standard and superfast move adversely, then that will slow down the transfer to superfast broadband. I think you would accept that as well?

A. Yes, and in particular I think -- well, I like the term "slow down" because that is probably the way I tend to think about it. What we are looking at here is superfast is a better product, people's need for it increases over time, video games and the kids' behaviour, et cetera, starts to demand it. And what you will typically expect is that you will have a flow of customers. The people who start to think: do I want superfast? Am I prepared to pay this premium price for it? As time progresses, more of them will start to think that. As each sort of cohort, each sort of group -- let's suppose there's a couple of million a year of people who fall into this. Each couple of million will go through and they will make a decision: do I upgrade or not, and the level of the price of VULA will influence that decision. So if the VULA price -- sorry, be clear, the retail prices for superfast broadband will influence that decision.

So if the retail price of superfast broadband is unduly high, then maybe those two million people don't upgrade that year. But, as time progresses, their need for superfast will increase and maybe they will upgrade. It is quite important what stage of the market development we are in. So if we think of those first couple of million customers thinking: do I upgrade or not, and think about, well, what are the incentives to set a high fibre price, the problem is, well, if I set a high fibre price, none of them are going to upgrade. So that is no help to me at all. So I have to set a low fibre price.

Let's suppose we move on a couple of years and now you have two million people who are on fibre and there are another two million thinking: shall I upgrade? There you have a choice; I can set a high fibre price, which will make me more money on the ones who have already upgraded because they are probably not going to switch back again, but I am going to lose that two million who are thinking of it. So that might still lead you to set quite a low fibre price.

Ratchet forward to when you are up to maybe half the market or more. Now we have really quite large numbers of people who are signed up to fibre who are perhaps less likely to switch back. You still have two million people thinking: shall I upgrade? Now your calculation will be, okay, I can set a high fibre price and now I'm going to earn that high fibre price on a lot of customers, but I still have to take into account I am going to lose the two million.

So essentially, as fibre becomes more important over time and as people are ratcheting up and as more of the consumer base basically decides they are going to have fibre and not standard, the degree of that constraint is going to change. This will have implications for what BT's precise trade-offs might be, when they think, well, do I set a high VULA price taking into account the risks, or do I look to the gains from my consumer business.

So again, for example, let's suppose they set a high -- sorry, I do apologise for running on a little bit but they are useful points I think. Suppose they set a high VULA price this year and let's suppose that 500,000 Sky or TalkTalk subscribers were thinking: we will upgrade. But now they face a higher price as Sky and TalkTalk increase their prices and they decide: no, it's not worth it. So Openreach loses revenue on those 500,000. So this would be RBB's point that quite a lot of those people who you set the high price to when they are thinking of upgrading will simply stick with standard broadband. So you lose the revenue on the 500,000.

But let's suppose there is another 500,000 who think, actually, I do want fibre so I'm going to go to who has the best offer in the market and that is BT, because Sky and TalkTalk have put their prices up. So BT Consumer gains, it gains some of those subscribers but not all of them and that is what you would expect.

Think about the calculation that one might make. Well, when somebody switches from Openreach -- when somebody switches to BT Consumer they are going to expect to get that revenue not just for one year, they will get it for the customer lifetime, we assume five in our price squeeze condition. BT's actual customer lifetimes tend to be higher than that. So BT Consumer is going to get that extra retail margin for potentially quite a long period of time.

In the case of the Openreach losses, what you might find is, yes, they don't upgrade. So in this year they are not going to shift up, but maybe in two years' time, when the need for fibre et cetera has got even stronger in the household, they may decide to upgrade. So Openreach will pick up perhaps that business a bit later, maybe in two years' time, so that can affect the trade-off.

Q. Yes. I see the time and if I could just roll this up. I think you accept that there could be a slow-down effect on the shift to superfast broadband?

A. Yes. It's a slow-down effect though it's not the whole of the 50 per cent of the market that would remain on standard broadband would be liable to shift between superfast and standard depending on the price. There will be quite a lot of those standard people who probably won't think of upgrading for a very long time.

Q. I think you accepted that half the market will still be out there in 2016/2017 on current projections, so it's big business?
A. It is big business if they would be the cohorts likely to upgrade. As I said, probably in 15 years' time we will all be talking about -- there will still be some sticking on standard broadband and one will wonder why they haven't. But essentially it's a flow. So of that 50 per cent that remains on standard, the flow of upgraders will not be all of the 50 per cent, it will just be a proportion of them.
Q. Yes, but just to stop for a moment, I think you have accepted that there are complicated issues here?
A. Yes.
Q. And I think we have already touched on the fact that the central part of Mr. Bishop's critique is that none of this was properly thought through. You looked at the market shares, you said there was a risk and we have discussed that, and that was enough, even that there might be a ghost of a margin squeeze. So we say that is just not enough.
But we haven't quite finished to perhaps we can come back at 2 o'clock?
MR. HOLMES: Sorry, was that last observation a question? If so, could Mr. Matthew be given an opportunity to answer it?
MR. THOMPSON: I anticipate you won't accept that the market analysis was deficient in the ways I have said but you understand that is BT's critique of it?
A. The RBB critique is that we think we have shown there is a real and significant risk without needing to do that analysis.
MR. THOMPSON: Yes.
THE CHAIRMAN: How much longer do you think you are going to be?
MR. THOMPSON: We have ranged about a bit differently from the way I anticipated and I haven't touched on effects, but I would hope it won't be more than half an hour. Certainly less than an hour.
(1.05 pm)
(The luncheon adjournment)
(2.00 pm)
MR. THOMPSON: Good afternoon, Mr. Matthew. You may remember on Friday we were discussing the undertakings and equivalence of inputs, and I think you said you would have a look at your statement and -- the statement, and I don't know whether there was anything to report from that exercise?
A. I did my homework, and I did a word search and confirmed that the undertakings are not

mentioned in my statement. They are also not discussed in the final statement in detail in the sections I was responsible for. I did also look back, and I don't think they were raised as a detailed matter by BT in its response to the consultation document so that may be why it's not specifically picked up, but that was the result of my search.

Q. Thank you. For the remainder, can we look briefly -- we were looking to some extent at this before lunch, the position in relation to the future, and we looked at the position of Virgin briefly and then you were looking at the risks as you saw them. Just to take it as shortly as I may, you are obviously aware that there is the issue of Sky and its position in pay-TV and its position as the leading triple play supplier of bundles. Would you accept that, in reality, there is no realistic prospect of Sky being excluded from the broadband market given those advantages it has?

A. I think -- certainly I accept Sky has a very strong position in pay television. In terms of the likelihood it would be completely excluded from broadband, probably not. As I understand it, Sky to a degree will use broadband as a cross-sell, so they get added value out of it, cross-sell to their pay-TV subscriber base. As long as it is profitable for them to offer those I am sure they would continue to keep it in the shop window, but naturally there will still be an element of degree about it. It is one thing to say, yes, you can get broadband from us, it is another to be saying we are really pushing this out to our subscriber base.

The story of recent years, I think -- it is probably -- I don't want to oversimplify it, but a story of recent years has been that Sky has rolled out broadband to quite a large part of its pay-TV subscriber base and that has been a significant issue for BT who has had to (a) risk losing subscribers, and (b) respond in the way they have.

Q. Yes, and I think we discussed the free twelve-month fibre offer which Sky made which indicates that they are quite capable of making pretty strong commercial moves, and I think you said in support of their triple pay position, and you would accept that?

A. I certainly accept Sky has demonstrated its ability to make strong commercial moves in a variety of areas and it is offering aggressively priced superfast broadband offers at the moment.

Q. Yes. Then looking at it more broadly, and we talked about TalkTalk and Sky for obvious reasons, and they are the leading third and fourth players in terms of this whole market, and second and third in terms of the overall market, I put it two ways.

First of all, from where we are now, and you have shown the graphs in your statement, it doesn't look realistic that their position in the overall broadband market is jeopardised, would you agree that?

A. Sorry, I didn't catch the earlier part. Is that other providers?
Q. No, the position of Sky and TalkTalk in the overall broadband market, it doesn't look like it is jeopardised, they are established players in that market, you would accept that?
A. Yes.
Q. And if I put it in another way, and you will obviously be familiar with the relevant market guidelines and things of that kind, even if they weren't selling superfast broadband at all at the moment they would be very obvious supply side alternative competitors to enter the superfast broadband segment that you'd take into account if you were thinking about superfast broadband, would they not, and there they are?
A. Yes, if you were to ask the question today: if TalkTalk and Sky didn't have any fibre customers at all would they be potential competitors? Then clearly yes.
Q. Yes. And it is all in the pleadings so I don't think we -- but you know that they have regulated inputs on the standard broadband and have done for many years, and they have grown their business in that field as a result?
A. Yes.
Q. Can we now look at the past position which you deal with at paragraph 84 of your statement. The first point is the point we started with and the incentive effects of past regulation, and we discussed that on Friday, if you remember?
A. Yes.
Q. Then the second point you make is that:

> "BT has argued strongly against Ofcom's VULA margin condition on the grounds it might constrain BT's flexibility going forward which suggests that BT believes the price squeeze constraint might prove to be binding."

I think you understand what BT's complaint is, which is -- and Mr. Petter and Mr. Tickel were very eloquent on the subject, that it's a badly designed condition that constrains them inappropriately, that it gives competitors far too much headroom, if I can put it that way. So that is the complaint, isn't it, not that it might prove binding?
A. Yes, I do understand. So BT argues that the price squeeze arrangements that we have put into the condition are too favourable to competitors. So I -- essentially they object. I took the objection to be partly -- well, obviously one doesn't want to have regulation unnecessarily, but also that there is a possibility that the price squeeze condition that we have used might be binding on them at some point.
Q. Yes, and I think Mr. Petter has explained that particularly at the start he was very concerned, when the substantial number of millions of investment in Champions League came into the

reckoning, that judged on a monthly basis, it might be difficult to recover that particularly at the start when you are trying to grow your base, and that was to some extent what was taken into account in the supplementary guidance, you understand that issue? That was the concern.
A. Yes, these are the issues I am sure the CMA will be deliberating on.
Q. And then the third one -- I don't want to be unkind but it just looks like a bit of speculation that BT's incentives to price squeeze might change as the market develops. That is obviously true in itself but it doesn't take things much further, does it? There is no real quantity of analysis or anything of that kind, it's just a bit of a punt, isn't it?
A. It is certainly not quantitative. I think it is slightly more than a punt. BT argues that essentially Sky and TalkTalk have not invested in fibre up until very recently, that is one of their points, which rings broadly true to me, and the situation is now expected to change, so Sky and TalkTalk are now promoting fibre. So in that -- in the first situation we are kind of in the world where precisely what level of VULA price BT sets probably wasn't going to make that much difference, but the level at which they set it was sufficient that for whatever reason Sky and TalkTalk weren't pushing the products and BT weren't price squeezing them. Going forward, the trade-off may well change in a world where they are actively pushing fibre.
Q. But I think the point that RBB make is that again you seem to be put things a little bit on one side and not on the other. But Ofcom spent quite a lot of time over the last two years investigating a complaint from TalkTalk and found that it was unsubstantiated. You remember that?
A. Yes.
Q. I think the other point that RBB makes is that the last two years were a particularly good crucible, as it were, for testing what the incentives are because the regulation has been as it was, Sky and TalkTalk have started to move into this market, and Ofcom has conducted a detailed analysis and given BT a clean bill of health. So the past actually is quite a good -- as it happens, you have a very recent precise examination of this very market in these very market conditions so it seems wrong to just discount them, don't you think?
A. I think as a matter of assessing what BT's incentives are, this is essentially my first point. When they are subject to the old arrangements, one cannot conclude from their conduct that they wouldn't have incentives to price squeeze because there were arrangements in place that limited their ability to do that. One might have a discussion about whether the old arrangements were sufficient and more proportionate than the new ones, but that is about

how you specify the remedy, not about whether there is an incentive in the first place.
Q. Can we move finally now to the issue of effects and I think we have discussed already, and it is obviously a critical issue, just as I think Mr. Holmes put it to Mr. Bishop, that there is an interplay between incentives and effects. But from our perspective, until we know what it is that you are frightened might happen, it is difficult to know what the effects will be and I'm still a little bit uncertain about what it is exactly you think BT might do.
But from some of your answers this morning it seemed to be that there were really two things: one, that there might not be sufficient margin for a competitor to cover not just its variable costs but quite a substantial chunk of fixed and common costs so that it could invest and that that is the sort of level that you are talking about, so quite a substantial margin needed for that purpose.
And then secondly, there is the ghost of a risk point, that you seem to be saying that even if there wasn't such a risk, if TalkTalk and Sky thought there might be, that would be enough for you to regulate BT's margin.
That seemed to be the two points that came out of what you were saying. Would you accept that or not?
A. That is not a summary of what my witness statement says. Sorry, I can't recall precisely what I said this morning.
Q. No, but there are a lot of different possibilities and then you gave a number of quite long answers and one of them certainly seemed to be that the margin needed to be enough not just to cover short-range costs but also quite a substantial element of, if I can put it, investment costs or --
A. Yes.
Q. -- something of that kind?
A. Yes, our view is when it comes to setting the benchmark the cost standard ought to be LRIC plus, and that entails in this case material gross margins.
Q. Yes, but I think you also accepted it was good enough if you didn't actually have that concern but if competitors were worried that there might be such a concern?
A. I think my point was even if BT doesn't actually implement a price squeeze, if competitors believe it might that will affect their incentives to invest in competing.
Q. So that was the sort of standard you applied?
A. It was an additional point.
Q. I don't think you did accept, but it is quite prevalent in your statement, that there is an underlying policy concern that the structure of the superfast broadband market might not

be the same as the structure of the existing broadband market, and you find it at 90 and then at 94.
You seem to be suggesting at 94 that the loss of one of the competitors ... so it seems to be focusing on the structure, but it is particularly I think at 35 and 90 where you talk about the different structures. So that does seem to be a concern, that you want to as far as possible move towards the same sort of structure as for the overall broadband market, is that right? That seems to be a pretty consistent theme in your statement.
A. Yes. As I said this morning, the final sentence of 90 makes this clear. I see the relevance of this as being about the context, the possibility BT might impose a price squeeze, not that we have any particular distribution of market shares in mind as something we would necessarily wish to see.
In terms of 94, 94 observes that in a situation where you have a four firm oligopoly and one of them either becomes materially less effective as a competitor, or even exits, that that would have a material detrimental impact on the competition probably for quite a long time and possibly indefinitely which I think is a reasonable point of view to take.
Q. Then paragraphs 95 to 99 are devoted to, as I understand it, essentially somewhat playing down the constraints that are imposed by standard broadband, is that fair? That seems to be the gist of the analysis here, to effectively talk down standard broadband?
A. I'm not playing it down, I am observing that there are -- well, we can go through all the points. I am observing that what we have here is, well, while they are in the same market they are not perfect substitutes such that any movement in the price of superfast broadband is going to lead to the whole market shifting back to standard. They're differentiated products and there are further points being made.
Q. I'm not sure whether you said you were or weren't involved in the Wholesale Broadband Access Market Review?
A. No, I wasn't.
Q. And the Fixed Access Market Review?
A. My involvement was the VULA margin consultation process --
Q. But you are obviously aware, and we won't go back to them, the findings, the detailed findings in the first two reviews, the wholesale broadband access, section 3 and the fixed access, section 7, and presumably you were involved in the no material change assessment in section 2 of the final statement? Or perhaps you weren't, I don't know?
A. Again, they're broad level. Sorry, you would have to ...
Q. Shall we look briefly at that then. Paragraph 2.15 of the final statement, page 10.

A. This is where we essentially pick up the WBA product market definition of --
Q. Yes. We have been through it a number of times, I won't go through it again. This effectively picks up section 7 of the FAMR analysis which picks up section 3 of the wholesale broadband access and at 2.15 there is a conclusion that it hasn't changed. And if we went right back to wholesale broadband access there is a section on future development in that review, and I take it that you are abiding by that given the terms of this.
We have also mentioned, I don't think we looked at it, but you recall the passage about why a cost control was not introduced in the FAMR, and the first reason -- we can look at it if you want -- is the constraints from standard broadband, do you remember that?
A. Yes.
Q. In cross-examination of Mr. Bishop, two new pieces of evidence were adduced on this issue which I think Mr. Holmes described as the best evidence available which is paragraphs 18 and 30 of Mr. Heaney's witness statement. That is at tab 14 of bundle II. You see it's in yellow, so it's confidential, but we won't go into it so we won't read it out --
A. Could you give me the paragraph?
Q. Paragraph 18, it's about page six.
A. Yes.
Q. Without giving away any confidential information, it is addressing the question of switching between retailers, I think that is reasonable.
A. Yes.
Q. I don't want to be mischievous, but if this were the best evidence available there would appear to be some difficulties in that it doesn't distinguish between standard broadband and superfast broadband, so it doesn't really cast any light about what the pattern of switching is in relation to superfast broadband. Would you accept that?
A. I'm not sure what my confidentiality restrictions are here. TalkTalk is discussing destinations of where customers might go, is that at a high enough level? And it has some numbers. And I think is your question: if TalkTalk were to produce similar numbers for its fibre subscribers that might look like a different story? Or is your question: for TalkTalk subscribers for all broadbands, that doesn't necessarily show where the ones who took fibre have gone to?
Q. No, exactly. And some of them have gone to Virgin, I think I can say that without breaching confidentiality, some have gone to Plusnet, some seem to be going to a reasonably premium product, some to a reasonably cheap product, and it is not clear -- and larger numbers are going to Sky and the largest numbers seem to be going to BT, I think, one can probably go

that far.
A. Yes, I agree, it is not just for people who are going to take fibre.
Q. So I don't know whether it's the best evidence or not but it is not very good evidence, is it?
A. It's the best evidence I see. And then would the numbers be different for fibre? Probably, yes. But as a general indication of Virgin's role in the market, it seems a reasonable point of reference to me. Essentially they are not one of the major destinations.
Q. Then paragraph 30, which is the other jewel in the evidential crown, is the prospect of spin down from superfast broadband to standard broadband. Mr. Heaney says that if someone has superfast broadband they are highly unlikely to switch back to standard broadband. Then there is a piece of confidential information I don't think we need to worry about. But I think this issue was considered by Ofcom right back in the Wholesale Broadband Access Market Review, and, without looking at that, I think one can see that in itself it doesn't cast much light on this debate, does it, because as Mr. Bishop said, and I think in fact he probably understated it, at least half the market will be either on standard broadband or voice only even in 2017. So there is a big market to play for apart from whether or not someone might spin down. So that doesn't really cast much light, does it?
A. I think I did give a very long answer earlier on this theme. It is relevant -- presumably this will be correct. It is relevant because what it means is as the flow of people trade up, if you raise the price of superfast broadband, not many of them are going to come back again. So it will affect the incentives to set higher fibre prices relative to standard prices, relative to a situation where people trade up but then are always happy to move back again with relatively modest price movements.
Q. Yes, in terms of the big picture effect on competition, if there are still 10/15 million households out there to compete for, that is still a big battlefield whatever the position on spin down, you would accept that?
A. Yes. So there would still be -- certainly by the end of this period there would still -- a lot of the market will not have traded up and that process will be continuing. As I said earlier, I suspect there will be a rump who will just simply not or not want to trade up for a very long time period. So it's not the case that a whole 50 per cent is going to shift between fibre and standard in response to modest price movements. But overall I would expect fibre to become more differentiated for that reason in the eyes of customers, and also there is simply the overall weight of fibre in the market is going to start to get really quite large. So even if you continue to view them as being in the same market, fibre will matter.
Q. Yes. But I don't think you would really dissent from Mr. Bishop's point that there is a bigger

world out there so this question is only a narrow part of the overall assessment?
A. It is part of it, but I think if the outcome were that as a consequence of a price squeeze TalkTalk and Sky were excluded from what is going to become fairly shortly the majority of the market, that would be expected to have an effect whether or not we decide the markets continue to be one or separate.
Q. I have two last areas. First of all, the question of what might be called the re-entry issue which is you will understand that both in areas such as predation and margin squeeze, there is a question which is sometimes called the recoupment question, which is not a necessary condition for a margin squeeze but I think it is generally regarded as an important one, whether there is prospect of some form of payback in the future. I think you didn't like the concept of sacrifice, but I think it is usually pretty well understood that the monopolist endures a certain amount of pain in the hope that in the future it will get more pleasure, and I think to some extent that is what your analysis has been touching on.
But if one looks at the points you make I think at 111 and 112, in relation to Virgin, it is clear that Virgin will always be present because it is not dependent on this input, and I think that is one of Mr. Bishop's concerns about the credibility of the case. You would accept I think that Virgin will be there for the foreseeable future and appears to be intending to expand considerably over the next five years. Would you accept that?
A. Yes.
Q. So that would make any form of recoupment difficult, to put it no higher than that?
A. It would make it more difficult and the scale of recoupment you would expect would be lower than if there was no Virgin network at all.
Q. I think you have also accepted in reality that there is no reason to think that either Sky or TalkTalk will ever go because they will be there on the standard broadband market on regulated inputs, isn't that true?
A. That is a good question. As I said before, I think for Sky this is a cross-sell, so they will always be prepared to cross-sell and the degree to which they do it may be affected.
TalkTalk it is a bit more speculative because they don't -- in Sky we can certainly see they have a very strong position in pay television and I think my report says TalkTalk doesn't obviously have any advantages at all, and a couple of other contextual points. If you look at TalkTalk's share of overall broadband now, it is certainly sizeable and they are one of the big four, but it is not huge and it has been going down over the last five years, six years, I think.
I don't think they are going to exit their existing business but to me it's not inconceivable

that a price squeeze on VULA would lead TalkTalk to essentially give up on fibre and simply focus on maximising what money it can make out of its -- I think I used the term "dwindling" copper subscriber base.

Q. The other factor which I think both you and Mr. Clarkson have tended to slightly play down, although it does appear in your evidence, is the possibility that the VULA charge will be reviewed and I think the logic of Mr. Clarkson's evidence is that at some point in the future it may be regulated. That is clearly a possibility and was considered last year and will no doubt be considered again. If that were the case, then the prospects of recoupment, if I can put it that way, would be undermined, would they not?

A. You are certainly right to say that is a possibility but I don't think it undermined -- it undermines the ability to recoup compared to a situation where BT could permanently set a very high VULA price such that their rivals could never ever come back into that part of the market and increasingly the market overall.

But if they do face regulation, what will happen is, yes, someone like Sky will be able to more profitably sell fibre than it otherwise would and that will create more of a competition to BT Consumer than would be the case if BT was able to continue to exclude. But the concern we would have is, in the meantime, BT has built up a very large lead in this particular segment, and very probably in broadband overall, it will take rivals time, money and investment to win that business back from them, there is customer inertia and other things around in these markets that are fairly well known. So BT would expect to continue to make retail profits out of that position in the longer-term.

Q. I won't go back over the incentives issue. You will recall we debated the incentive effects for BT Consumer and the share price et cetera, all that issue about where it might go. But there is in fact another point which is in the decision itself which is at paragraph 4.28. You will recall the issue. There is a main text and then there is a confidential item which I won't go into but which the Tribunal may wish to read. (Pause)

The reason I take you to it is in relation to the issue of risk and whether the -- what I might call the Domesday scenario of BT charging an inflated price into the future indefinitely was really a realistic possibility that should have been a concern to Ofcom. Because your response is all about conduct on the retail market, and I'm not sure you accepted it, but I certainly put it to you that that is really not the business of this regulation of the BT wholesale price. And insofar as a cap could have been applied, that would I think address the Domesday scenario of an indefinite VULA price going into the future, would it not?

A. So this -- the material in the highlighted text at the end of 4.28 concerns how effective the

proposal would have been.
Q. I think the main text stands on its own.
A. Yes, sorry, you took us to that. I was just observing about it. As to the general question --
Q. Sorry, did you mean the blue text in 4.28 itself?
A. Yes.
Q. Yes, I am sorry.
A. But the general issue here is essentially, again, what is the right remedy? I think if you have an effective price cap on BT, and depending on the level at which it is set, then you may have different views on how tight a price squeeze condition you might need to go with it. So that would be something you would weigh up. We weighed up this proposal and decided we didn't think it was wise.
Q. We discussed Mr. Petter's point, we discussed the possibility of future price control, and I will leave it there.

Can I finally ask you about the approach that I understand is really the idea that the margin must be sufficient to cover fixed and common costs and that is the level you have sort of set it at. Can I take you to 7.50 in the decision. It is in particular the passage after the footnote 812 where you say you recognise:

> "... this may in itself still lead to BT having higher retail superfast broadband prices than might occur in the absence of a control."

Then you say that is outweighed by the long-term dynamic benefits of future competition. But would you accept that your approach creates a significant risk of consumer harm in the form of increased short-term prices?
A. The margin condition we have proposed?
Q. Yes.
A. Certainly we hope it won't.
Q. I'm sure we all hope it won't, but would you accept that this approach of giving what we would call an umbrella intended to protect LRIC plus fixed and common costs does create a risk of higher short-term retail prices?
A. It could be the case that it would. It not necessarily is, but it could be in some circumstances.
MR. THOMPSON: Those are my questions, thank you.
MR. HOLMES: I don't have any questions.

Questions from THE TRIBUNAL

PROFESSOR MAYER: Can I perhaps just turn to the last part of your document and in particular the part where you talk about responding to the additional analysis that could have been done. I would like to have your views.

You conclude it by saying:

> "I do not think that embarking on a detailed attempt to quantify BT's incentives to impose a price squeeze would have advanced matters further."

The question I would like to ask is: if, for example, we focus on this last point that was made about the potential impact on consumer prices from imposing a margin squeeze, do you not think that there would have been some merit in evaluating the extent to which that could have had a detrimental effect in relation to the potential loss of competition in the market from not having a margin squeeze?

A. I think it is certainly highly relevant to the design of the remedy. Essentially, when we stepped through the analysis of how we should go about setting the margin condition, we looked at that quite closely. So essentially we considered three cost standards, LRIC -- sorry, all LRIC plus. The first was assume we have an EEO, so the same costs to BT. Secondly --

MR. ALLAN: Sorry, can you just speak up, Mr. Matthew.

A. Sorry. So the first standard we had was to ensure that a competitor with the same costs as BT could properly match their offers. The second was a competitor with slightly higher costs, and by that we essentially meant a competitor -- a situation where BT had unmatchable advantages broadly linked to its long-standing strength in the marketplace. And then the third was one where we said we should set it so that a competitor with slightly higher costs than BT should be able to substantially undercut BT. And we rejected that third one in particular because (a) we thought it wouldn't help out, but (b) because we certainly recognised that that would be liable to lead BT to increase its retail prices, potentially, and also it had other adverse things associated with it.

In respect of this, my comment here is essentially about the risks that BT has incentives in this area and it acted on those incentives, whether that would be potentially damaging. Our view was very clearly that, given the market evidence we saw, it is clear there was a real and significant risk of them having those incentives, for me well beyond that sort of standard. Therefore we didn't see the need to go into all of those more detailed things. But I do appreciate that when it comes down to how should one design the remedy, they are more relevant.

On the BT Sport issue, which is probably the biggest bone of connection in how we designed the remedy, that is no doubt one of BT's arguments.

PROFESSOR MAYER: So it is less about the incentives and more about a cost/benefit analysis in relation to alternative remedies.
A. Effectively that, yes.
PROFESSOR MAYER: Thank you.
MR. HOLMES: No questions arising out of that, sir.
THE CHAIRMAN: Does that conclude your evidence?
MR. HOLMES: It does, sir, yes. Thank you very much.
THE CHAIRMAN: Thank you, Mr. Matthew.
(The witness withdrew)
MR. THOMPSON: Sir, I don't know -- I think we now adjourn until Wednesday.
THE CHAIRMAN: Yes.
MR. THOMPSON: I suspect it will be preferable for everyone if we could finish on Wednesday but I'm in the Tribunal's hands. If the Tribunal wanted to start at 10 o'clock rather than 10.30 am, I would be happy to do that, or we can just start at 10.30 and see how we go. I don't mind. Which is better for the Tribunal?
THE CHAIRMAN: What I was going to suggest, and this may have some bearing on the start time, is that the parties may each like to produce a list of issues which they consider the Tribunal will have to address in its judgment.
MR. THOMPSON: Yes.
THE CHAIRMAN: Together with, in relation to each one, each issue, the findings which you would invite us to make, and together with, as far as any findings of fact are concerned, relevant references to the transcript and to the witness statements. I appreciate that is quite a lot of work but I believe that may be helpful both -- it will be helpful to us I'm sure, and it may be helpful to you in terms of the structure for your final submissions.
I was going to suggest that if you could each do that by tomorrow at 5 o'clock, let's say, that would give us time to look at it overnight, and in that context I would think it is probably best to start at 10.30 am rather than 10 o'clock to give us a chance to discuss it in the morning.
MR. THOMPSON: It certainly gives us some focused homework to do overnight. Subject to what anyone else may say, I am happy to undertake it on behalf of BT.
MR. HOLMES: Of course if the Tribunal would find that helpful, we will do our best. The document may be a more considered one if it were to be put in after oral closings, but this is something that you would find helpful for the purposes of structuring the final day of proceedings?

THE CHAIRMAN: Yes. There is nothing to stop -- and we can perhaps look at that after we have had the final submissions. It may be that it can then do with some perfecting after we have had the oral submissions, but I think it would be helpful as a prelude to the closing submissions to have that ready.
MR. THOMPSON: Yes. I think the stages were the issues and the answers, and then the third was the references to the evidence. I suspect the third may be the most burdensome.
THE CHAIRMAN: I can see that, but ultimately it is going to be helpful to us to have references to the transcript certainly so that we know which bits you would like us to focus on.
MR. THOMPSON: Yes.
THE CHAIRMAN: See how you get on. If it proves to be a completely impossible task --
MR. THOMPSON: Hopefully there will be some match-up between the issues but we'll see.
THE CHAIRMAN: Yes. Again, if there was more time available I would encourage you to try to agree the list of issues but I think that is too much to ask in --
MR. THOMPSON: I think that may be difficult, but we will try and come up with a logical set of issues and see whether Mr. Holmes comes up with the same ones or a completely different set.
THE CHAIRMAN: If that happens that will only, I think, underline the need to be clear what the issues are.
MR. HOLMES: May I check one final point. I understand this is in relation to the issues that engage the evidence.
THE CHAIRMAN: Of course.
MR. HOLMES: There are some legal matters. Did you envisage --
THE CHAIRMAN: I am glad you touched on that because we did have in mind that it would include the legal issues as well. One of those issues is the issue of the nature of the risk assessment under section 88. I don't want to constrain you too narrowly, but if the starting point for these purposes is that a risk means a chance of something happening but not necessarily more likely than not, in other words, if it is -- how risk is generally understood is a matter of common parlance.
Is it sufficient -- you might want to write this down actually -- is it sufficient for Ofcom to show, first, a risk of engagement in a price squeeze together with no more than a risk but not necessarily a likelihood of adverse consequences for end users, or must Ofcom go further and show a risk of a price squeeze together with a probability that the price squeeze will have adverse effects?
So is it risk plus risk or is it risk plus probability, ultimately, in short.

MR. THOMPSON: Yes, and there is a sort of conceptual element and then there's a matter of statutory construction as well, both unfortunately at the EU level and the UK level, so there are quite a number of underlying issues, but we can certainly think about that and try and make our position as clear as we may in writing by 5 o'clock and I will try and make it yet clearer on Wednesday morning.

THE CHAIRMAN: Thank you.

(2.55 pm)

(The hearing adjourned until 10.30 am on Wednesday, 16th December 2015)

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