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IN THE COMPETITION
APPEAL TRIBUNAL

Case No: 1284/5/7/18
1290/5/7/18

Salisbury Square House
8 Salisbury Square
London EC4Y 8AP

Tuesday 7 June 2022

Before:
The Honourable Mr Justice Michael Green
Derek Ridyard
Sir Iain McMillan CBE FRSE DL
(Sitting as a Tribunal in England and Wales)

BETWEEN:

Royal Mail Group Limited
BT Group PLC and Others v DAF Trucks Limited and Others **Claimants**

v

DAF Trucks Limited and Others **Defendants**

A P P E A R A N C E S

Tim Ward QC, Ben Lask and Clíodhna Kelleher (On behalf of RM/BT)
Daniel Beard QC, Daisy Mackersie and James Bourke (On behalf of DAF)

Tuesday, 7 June 2022

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(10.00 am)

THE CHAIRMAN: Good morning.

Mr Ward?

MR WARD: Sir, I just wanted to know if you wanted me to ask Mr Harvey to confirm his reports in the formal manner or whether you are content for him just to be sworn.

THE CHAIRMAN: I do not think that is necessary, but he will have to be sworn in.

MR WARD: Yes, okay.

MR JAMES HARVEY (affirmed)

THE CHAIRMAN: Thank you, Mr Harvey.

Cross-examination by MR BEARD

MR BEARD: Good morning, Mr Harvey.

A. Good morning.

Q. Now, the tribunal has heard economic expert evidence from you on various issues and you have a BSc and a Masters in Economics; that is right?

A. That is right.

Q. Yes, but you are not an accountant, are you?

A. I am not.

Q. No. You say that with some pride, Mr Harvey.

A. It was not intentional!

Q. Now, you have a team working for you at Economic Insight; that is correct, is it not?

1 A. That is correct.

2 Q. Yes. Mr Sam Williams is a member of the confidentiality
3 ring in these proceedings, is he not? Is that correct?

4 A. That is correct.

5 Q. So he is part of the team working on this case and he
6 used to work at Royal Mail; yes?

7 A. He has not been working on this case.

8 Q. He has not been working on this case?

9 A. No.

10 Q. Right. So he has not assisted you in preparing any of
11 your materials?

12 A. No.

13 Q. No.

14 Now, I saw from your website that Economic Insight
15 has had quite a long relationship with Royal Mail going
16 back to sort of 2012?

17 A. Yes.

18 Q. Yes.

19 In 2016, when the Commission published or made the
20 announcement of the infringement decision, you put
21 out -- not you personally, but you put out a press
22 release saying that you were -- you had been hired by
23 a number of major buyers to help quantify damage caused
24 by the cartel; correct?

25 A. Yes.

1 Q. Yes.

2 Those buyers presumably included Royal Mail and BT
3 and Dawson Group and others?

4 A. I cannot remember in terms of the date, but likely, yes.

5 Q. So in relation to the claimants we are dealing with
6 here, you have been involved in the preparation of this
7 case right from the start, as it were, the announcement
8 of the Commission decision?

9 A. I am sure it would have been shortly after -- after
10 that, but close to that.

11 Q. So, again --

12 A. Sorry, for clarity, we would have been involved from
13 around 2016 rather than 2011 when the --

14 Q. Sorry, I was not trying to suggest you had been involved
15 since 2012 in this matter, no. It was 2016.
16 Understood.

17 From your website, again, I think there are 15
18 economists working at Economic Insight, does that sound
19 about right to you?

20 A. That sounds about right.

21 Q. Yes.

22 Now, in your report, you mention a couple of people
23 assisting you. In relation to Royal Mail I think it is
24 Paul Stoddart, Penelope Banks and Kyran Stewart?

25 A. That is correct, yes.

1 Q. Then, in relation to BT, Mr Stoddart again,
2 Alasdair Crookes and Natalie Luyt?

3 A. Yes, that is correct.

4 Q. Right.

5 They are all economists?

6 A. They are all economists.

7 Q. Not accountants?

8 A. Not accountants.

9 Q. No.

10 In fact there are 13 of the 15 at Economic Insight
11 in the confidentiality ring in these proceedings;
12 did you know that?

13 A. I probably did. It does not surprise me.

14 Q. No. Indeed there are some people in the room that no
15 longer work at Economic Insight. Did any of these other
16 people assist you in the preparation of your evidence on
17 supply pass-on?

18 A. No, I do not think so.

19 Q. No.

20 Just to be clear, none of the people that I am
21 referring to have any accountancy qualifications, so far
22 as you are aware?

23 A. No.

24 Q. No.

25 I think, as you have made clear, you are not just

1 working on the Royal Mail and BT cases, you are working
2 on a number of other cases in relation to the trucks
3 infringement; correct?

4 A. Correct.

5 Q. Yes.

6 So major issue for Economic Insight, but in any of
7 those cases have you got accountancy support?

8 A. No. Not my firm specifically, no.

9 Q. Right.

10 Now, we are going to be looking at supply pass-on in
11 the context of the regulatory regime and I think this
12 will be common ground, there are broadly five steps --
13 I mean, precisely how one breaks this down perhaps does
14 not matter, but the first thing that we are going to be
15 doing is identifying how the costs of trucks was
16 accounted for within each business; correct?

17 Then, the second step is going to be thinking about
18 how those truck costs were included in the forecast
19 costs put forward by BT or Royal Mail to their relevant
20 regulator?

21 A. Yes.

22 Q. Yes.

23 Now, there will then be further steps that we will
24 come on to dealing with, with how the regulator took
25 account of those costs and whether the price control it

1 put in place would have differed and, if so, whether
2 actual prices charged by the businesses would have
3 differed, but just focusing on those first two steps.
4 Those first two steps, identifying the cost of trucks
5 and how it was accounted for within the business and how
6 those costs were put forward by Royal Mail or BT, they
7 are either matters of factual evidence or forensic
8 accountancy, are they not?

9 A. Well, they are matters of fact how they were accounted
10 for. It is quite normal in the work of an economist to
11 have to consider accounting information and how it is
12 used.

13 Q. But you do see the difference between forensic
14 accountancy and economics?

15 A. Yes.

16 Q. I feel like I am entering a Monty Python sketch now
17 about jobs at the moment, but yes.

18 You accept that it is factual or accountancy
19 evidence in relation to those first two matters?

20 A. Well, it is factual evidence in terms of how the costs
21 were accounted for. As I say, I think it depends on
22 what specifically you mean by forensic accountancy
23 evidence and why that matters.

24 Q. Fair enough.

25 I want to look at some of the enquiries you made in

1 relation to these issues. Now, I think you are probably
2 aware -- I will take you to one example -- that
3 Mr Bezant, who is the expert accountant dealing with
4 these matters on behalf of DAF, asked for a significant
5 amount of information from Royal Mail and BT in the
6 course of the preparation of his reports. Do you recall
7 seeing those --

8 A. I do. I cannot remember the specific requests.

9 Q. No, I am not going to test you on the questions he
10 asked, but he asked an awful lot of questions.

11 A. Yes.

12 Q. You know that?

13 A. Yes.

14 Q. Yes, okay. Well, I will not take you to that.

15 Now, so far as we are aware, whilst Mr Bezant asked
16 an awful lot of questions, we are not aware of you
17 asking Royal Mail or BT further questions or seeking
18 further documents when you were preparing your reports
19 on supply pass-on. Did you do so?

20 A. No, I do not recall asking further questions.

21 Q. Can I also ask, did you speak to or make written
22 enquiries of Mr Jeavons when you were preparing your
23 reports?

24 A. No.

25 Q. Mr Barnes?

1 A. No.

2 Q. Mr Wills?

3 A. No.

4 Q. Mr Cahill?

5 A. No.

6 Q. Mr Dennis?

7 A. No.

8 Q. No. I mean, there is a theme here. Is it fair to say
9 you did not make any enquiries of any of the individuals
10 at Royal Mail or BT in the preparation of your supply
11 pass-on report?

12 A. Yes, that is fair to say.

13 Q. Thank you.

14 We will come on to deal with some of the specifics,
15 but we will see in your report on supply pass-on that
16 there are a number of points where you say, "I do not
17 know, I cannot be sure what happened", but what we are
18 identifying is that you made no specific enquiries to
19 clarify any of these matters with Royal Mail or BT,
20 whether obtaining documents or speaking to individuals,
21 did you?

22 A. No, I did not.

23 Q. No.

24 That is notwithstanding, clearly, the very long
25 relationship you have with Royal Mail. I do not know

1 how long your relationship is with BT. Correct?

2 A. Correct.

3 Q. Now, I want to turn to a couple of issues about your
4 consideration of documents and what you scrutinised
5 when. I am going to start with Royal Mail.

6 Just to set the questions I have for you in a bit of
7 context, I want to make sure we are in the same place or
8 at least understand each other, if not agree, on
9 a couple of underlying issues. Now, I do not want to
10 repeat matters which we have already addressed with
11 Mr Jeavons, but just to recap on a couple of the basic
12 accounting principles that are relevant for supply
13 pass-on analysis for Royal Mail.

14 The accounting treatment of a truck depends on
15 whether it was purchased outright or using financing
16 lease or via an operating lease, I think we agree on
17 that proposition?

18 A. Yes.

19 Q. Yes.

20 If the truck is purchased outright, the cost of the
21 truck is an asset on the balance sheet; correct?

22 A. Yes.

23 Q. That cost is the initial purchase price of the truck
24 including any putative overcharge; correct?

25 A. It depends.

- 1 Q. It depends?
- 2 A. It depends on whether the assets have been revalued at
3 any point in time.
- 4 Q. Revalued?
- 5 A. Yes.
- 6 Q. We will come back to some valuation issues in a bit, but
7 the initial purchase price is a cost that you would
8 expect, at least at the outset of the relevant period,
9 to be included on the balance sheet; correct?
- 10 A. Sorry, what do you mean by "the outset of the relevant
11 period"?
- 12 Q. Well, when a truck is purchased within a particular
13 year, you would expect that cost to be included in the
14 balance sheet for that year?
- 15 A. Yes.
- 16 Q. Yes.
- 17 So just to be absolutely clear, in the
18 counterfactual, if you are right about there being an
19 overcharge, the initial purchase price of the truck on
20 the balance sheet would have been lower; correct?
- 21 A. Yes.
- 22 Q. Yes.
- 23 Then you have depreciation charges, which are
24 calculated on a straight line basis over the useful life
25 of the vehicle; correct?

1 A. Yes.

2 Q. Yes.

3 Now, if the truck is purchased using an operating
4 lease, it is the lease payments that are accounted for
5 by the company; correct?

6 A. Yes.

7 Q. They are accounted for as operation expenditure;
8 correct?

9 A. Yes.

10 Q. I think you accept that the lease payments are
11 calculated themselves on the basis of the purchase price
12 of the truck; correct?

13 A. Yes.

14 Q. Yes.

15 So in the counterfactual, if there had been an
16 overcharge, your lease payments would be lower in the
17 counterfactual world?

18 A. Yes.

19 Q. Yes.

20 Just making this concrete for Royal Mail, Mr Jeavons
21 confirmed that vehicle service charges from Royal Mail
22 fleet to other parts of Royal Mail business included the
23 depreciation element on outright truck purchases and on
24 operating lease payments for trucks. Do you recall
25 that?

1 A. Yes.

2 Q. Yes.

3 So can we just go to an early version of the
4 particulars of claim, which I think you were probably
5 involved in the preparation of. Can we go to {B/1/48}?
6 Actually, let us just go to {B/1/1} to start with so we
7 can see the document.

8 So this is actually the re-re-re-amended particulars
9 of claim with many colours. At the top, you can see
10 that the amendments in red were dated 8 May 2017,
11 because in fact the original particulars were served
12 I think in early 2017 and then amended. I am not asking
13 you to confirm the dates, but I am just giving you
14 a sense of the dates of the original pleading which was,
15 as we understand it, early 2017. At least that was when
16 it was served. Then it was amended mid-2017. Then you
17 will see there are a series of amendments: 2018, 2019
18 and February 2021. Do you see that at the top?

19 A. Yes.

20 Q. Yes. That is just the colour coding.

21 Now, if we could just go through to page 48 {B/1/48}
22 in this document. That is the indication of the dates
23 of the actual pleading which I have taken you to
24 already. If we could now go on to page 86 {B/1/86},
25 this is appendix C to the particulars of claim. You

1 will see that is the "Value of Commerce" appendix. If
2 we can just go over the page -- and again, I am so
3 sorry -- I am sorry, again, I just want to go to
4 appendix D {B/1/89}. Yes. Then "Overcharge". If we go
5 down this page, we will see the overcharge table. There
6 are some redactions, it does not matter.

7 So these were served on us in 2017 and then have
8 been amended subsequently, appendix C and D. Now
9 I presume that you, given your indications, you were
10 involved in the preparation of these tables; correct?

11 A. Yes.

12 Q. Yes.

13 Now, I know that you do not now rely on the numbers
14 in those tables and you recognise, even on your own
15 case, that the numbers set out in the pleadings was
16 wrong, but do you recall what information you were given
17 for the purpose of producing those tables? Presumably
18 you were given data by Royal Mail about each truck
19 purchased by Royal Mail?

20 A. I cannot remember the data, I am sorry. But presumably,
21 yes.

22 Q. I see.

23 If we could just go forward to February 2021, so
24 this is around the time of the re-re-re-re-amendments.
25 February 2021, {G9/69/6} [sic]. You may remember this,

1 this is a witness statement you gave. Do you want me to
2 go back to the front page or do you recall it?

3 A. No, go back to the front page.

4 Q. Okay, if we can just go to page 1 (G/69/1}, just so that
5 Mr Harvey can see.

6 A. Thank you.

7 Q. It is your eighth witness statement in the Royal Mail
8 proceedings, your second in the BT proceedings.

9 A. Thanks.

10 Q. Now, I am happy if you want to look at any of the
11 introduction material, but I just wanted to go to
12 something on page 6 {G/69/6}, if I may.

13 A. Please go ahead.

14 Q. So 4.2, you say -- this is February 2021:

15 "In relation to the relatively small number of
16 trucks that Royal Mail leased rather than purchased from
17 the Defendants (50), I intend to calculate the relevant
18 value of commerce by multiplying the monthly finance
19 rental payment for each truck ... by the number of
20 months in the lease period."

21 Then:

22 "The monthly finance rental payment excludes any
23 explicit payment for maintenance services ... I will
24 multiply this value of commerce by the percentage
25 overcharge from the overcharge analysis outlined above

1 to calculate the overcharge in [pounds]. I have
2 considered other approaches, including carrying out
3 a separate overcharge analysis for leased trucks, but
4 consider that this is unnecessary and disproportionate
5 in view of the relatively small number of trucks
6 involved."

7 To be clear, in February 2021, you had been further
8 considering what the appropriate analyses in this case
9 would look like, and you considered that any sort of
10 separate regression or analysis on leased trucks was
11 irrelevant and that there were only 50 leased trucks;
12 correct? That is what you said there?

13 A. Correct, yes.

14 Q. Yes.

15 Do you recall at all which documents you had
16 reviewed in the preparation of this witness statement?

17 A. I am afraid I cannot, no.

18 Q. No.

19 Can we go to {H/IC8.1/1}.

20 THE EPE OPERATOR: That is a confidential one.

21 MR BEARD: I think it will be okay to open it. That is
22 great.

23 I just want to check, do you remember seeing this
24 spreadsheet at any point?

25 A. Yes, I do.

1 Q. Do you know when it was provided?

2 A. No.

3 Q. It is dated October 2018 and it is a spreadsheet from
4 Royal Mail; correct?

5 A. Yes.

6 THE CHAIRMAN: Sorry, where do we see that, October 2018?

7 MR BEARD: I think it is in the metadata. We can provide
8 that, but I think that has been checked.

9 THE CHAIRMAN: Right.

10 MR BEARD: I think you had not looked at this spreadsheet in
11 contributing to any of the particulars of claim or
12 indeed before writing your witness statement that I have
13 taken you to, had you?

14 A. I cannot remember.

15 Q. You cannot remember?

16 A. No.

17 Q. Well, let me assist. If you look across here, you see
18 the top, "Make", "Model", "Type", so "Make, DAF";
19 "Model", the sort of codes we are now slightly familiar
20 with; "Type, HGV", heavy goods vehicle; "Type 2", the
21 load carrying; "User"; "Workshop", so that is for other
22 elements added to the truck.

23 Then, you will see the column "Owned/Lessor"; do you
24 see that?

25 A. Yes.

1 Q. You see, if you work your way down, lots of blanks, and
2 then particularly "Owned Vehicles", "Owned Vehicles"
3 further down?

4 A. Yes, I can see that.

5 Q. Yes.

6 We only need to look at the start of this
7 spreadsheet to see on the first page lots of references
8 in the "User" column to Parcelforce?

9 A. Correct.

10 Q. So, in relation to Parcelforce, there is no indication
11 that it is an owned vehicle that is being talked about
12 in relation to those particular trucks; you understand
13 that from that spreadsheet?

14 A. Yes.

15 Q. Yes.

16 Now, do you first recall when you first found out
17 that, contrary to your witness statement and contrary to
18 all the pleadings you had advised on, there were not
19 just 50 leased trucks in Royal Mail's claims, but in
20 fact thousands of them?

21 A. No, I do not remember when I found that out.

22 Q. Well, I can go through the correspondence with you, but
23 do you remember there was a letter from Travers Smith,
24 the lawyers for DAF, raising these issues in July 2021
25 in particular?

1 A. I do not. I do not remember the date.

2 Q. No?

3 A. No.

4 Q. No.

5 Now, let us just call it up, {J3/IC490}, if you
6 would not mind.

7 THE EPE OPERATOR: That is also confidential.

8 MR BEARD: That is fine. Do not worry. Thank you for
9 checking.

10 If you just scroll down, you will see in
11 paragraph 1, as is often the case with these letters, it
12 is one in a long chain, and what it is dealing with, as
13 you will see from paragraph 2, are concerns about the
14 extent of the leasing of trucks by Royal Mail. Do you
15 see that?

16 A. Yes.

17 Q. Concerns that are being raised by DAF's experts?

18 A. Yes.

19 Q. If we just scroll down to paragraph 5 {J3/IC490/2}, what
20 is being said here, in paragraph 5, is, so far, the
21 experts for DAF, having looked at the material that has
22 been provided by Royal Mail, consider that there are at
23 least 3,000 trucks that were leased by Royal Mail. You
24 understand that?

25 A. Yes.

1 Q. If we go down to paragraph 10 {J3/IC490/5}, the obvious
2 point is made by them, that this will affect the expert
3 analysis, and I do not think you dispute that the number
4 of leased trucks that we are dealing with affects the
5 expert analysis in a number of ways, but in particular
6 in relation to supply pass-on; correct?

7 A. Correct.

8 Q. If we just go to {J4/17}, this is actually a reply from
9 Royal Mail's lawyers, BCLP. Paragraphs 2 and 3 are
10 somewhat remarkable in that they criticise DAF and DAF's
11 experts for failing to ask questions sooner about leased
12 trucks, but we will move across that.

13 Paragraph 4, if we could just go down to it, here,
14 strangely, the lawyers are asking what the relevance of
15 leased trucks might be to the expert analysis, but
16 I think you have just accepted that it is clear that
17 that was fairly obvious.

18 So, initially, there was reluctance on the part of
19 Royal Mail's lawyers actually to engage in this
20 discussion. But if we could then go to {J4/IC143}.

21 THE EPE OPERATOR: That one is confidential.

22 MR BEARD: Yes, that is okay. Thank you for checking again.

23 Now, this is the letter from Royal Mail's solicitors
24 to DAF's solicitors after various other pieces of
25 correspondence that are referred to in paragraph 1. You

1 see the date, this is less than a month before your
2 expert report was on -- in particular, on supply
3 pass-on, was lodged, 22 October 2021.

4 It is in this letter that finally we see that there
5 is an acceptance that the forensic analysis of the
6 documents that have been provided by Royal Mail, by
7 Royal Mail's representatives themselves, was
8 fundamentally wrong. So if we look at paragraph 4,
9 paragraph 4 is indicating that the lease information can
10 be found.

11 If we go just further down the page, you will see
12 that there is a more detailed exposition of the relevant
13 leasing arrangements. If we go down to paragraph 6
14 {J4/IC143/3}, we now see a very, very different picture
15 in relation to the relevant data, do we not? That the
16 trucks leased by Royal Mail that form part of the claim
17 are not 50, as you were saying in February 2021, but
18 over 5,000, and that is the correct number, is it not?

19 A. That is the correct number, yes.

20 Q. Yes.

21 Now, when did you first become aware of that figure,
22 Mr Harvey?

23 A. I cannot remember, Mr Beard. Sorry.

24 Q. No.

25 But it was presumably around this time, during the

1 course of the last stage of the preparation of your
2 reports; correct?

3 A. Yes, I would think so.

4 Q. Yes.

5 Now, that is two orders of magnitude wrong as
6 compared to your February witness statement in relation
7 to data provided by Royal Mail in 2018. That is
8 a fairly remarkable degree of error, and you had not
9 checked any of this data at all, had you?

10 A. No.

11 Q. You had carried out no forensic accountancy analysis in
12 relation to leasing or ownership by Royal Mail of the
13 relevant trucks at all, had you?

14 A. No.

15 Q. No.

16 Neither you, nor Royal Mail's other advisers
17 actually interrogated the Royal Mail data to understand
18 what was there in relation to these key metrics,
19 did you?

20 A. Well, I do not think that is correct. The spreadsheet
21 that you have shown -- taken me to contained a column
22 that says "Owned Vehicles". At the time, I thought that
23 more of the vehicles were owned, but I accept there was
24 missing data.

25 Q. Now, we can go back through the correspondence which

1 sets out how DAF's experts, looking at the same material
2 that was available to you, identified that there was
3 a fundamental error in your appraisal of all of that
4 documentation, I am very happy to do that, but you
5 accept that you had not looked at any of that material
6 and they were able to identify that thousands of trucks
7 appear to have been leased, did they not?

8 A. I accept that, yes.

9 Q. Yes.

10 Fundamentally, Mr Harvey, although when we will come
11 on to see that you say you are uncertain about matters,
12 the truth is you did not make the relevant enquiries and
13 you did not carry out the relevant forensic accountancy
14 exercise to make your report as robust as possible in
15 relation to the relevant metrics, and this is a very,
16 very clear example of that, is it not, Mr Harvey?

17 A. I do not think the conclusions that you have referred to
18 in terms of uncertainty necessarily are reflected by
19 these matters. It depends which conclusions you are
20 talking about I think.

21 Q. The point I am making, Mr Harvey, is not only that these
22 particular figures were missed, but the degree of
23 uncertainty and the lack of enquiry they evidence, both
24 of documentary material and, as you have very frankly
25 made clear, of any individuals at either Royal Mail or

1 BT, mean that where you say you are uncertain about
2 costings or pricing undertaken by Royal Mail or BT, you
3 have made no attempt to try and clarify those matters
4 with individuals at Royal Mail or BT, have you?

5 A. Well, it depends on the -- sorry. There is no attempt
6 to make a clarification question of Royal Mail on this
7 issue, but you are making a more general statement about
8 uncertainty and I do not think I can say yes or no to
9 that. It depends which uncertainty you are referring to
10 and the effect -- the extent to which it depends on
11 these figures.

12 Q. Well, it is not just these figures that is the matter of
13 enquiry, but I have put the point. I am going to move
14 on to another issue.

15 Another issue I just wanted to pick up was the
16 treatment of what is known as irrecoverable VAT.

17 A. Yes.

18 Q. You are familiar with that as a notion I think?

19 A. Yes.

20 Q. Yes.

21 If you do not mind, although you are familiar with
22 it, just so that the tribunal has it in mind, I am just
23 going to go to a passage in Mr Pritchard's report which
24 sets it out. I do not think it is controversial. Can
25 we go to {E/18/21}, please? I will not read it out, but

1 perhaps the tribunal and you, Mr Harvey, can just read
2 2.11, 2.12 to yourselves. (Pause).

3 I am not going to ask you to comment on the details
4 of it, but I think that is a broadly fair representation
5 of what the irrecoverable VAT cost issue -- or how it
6 arises; fair?

7 A. Yes.

8 Q. The point is, it is another cost matter that arises in
9 relation to questions of overcharge and the supply
10 pass-on which we will come on to deal with in due
11 course. But I just want to pick it up in relation to
12 your third report, Mr Harvey. Could we go to
13 {E/IC57/22}? Now, I should say there is information
14 here highlighted in yellow but we are not quite sure why
15 it is confidential. If we just scroll down, so:

16 "My updated approach to estimating the Overcharge
17 relevant to Supply Pass-On."

18 You say:

19 "Since submitting by Second SPO Report, further
20 information in relation to how ... Overcharge would have
21 been reflected in Royal Mail's costing system and in
22 charges ... has become available, and [so] my
23 instructions have been updated.

24 "For the purposes of my analysis ..."

25 So this was not an enquiry by you, this was an

1 instruction being given:

2 "For the purposes of my analysis which I present in
3 this report, I have been instructed to adopt (i) the
4 'corrected payment profile' that accompanies Delamer
5 Leasing 2 ..."

6 So that is Mr Delamer, who is expert for --
7 presenting reports on behalf of DAF:

8 "... save for the changes he describes at
9 paragraph 69(h); and (ii) of Delamer 2 and the
10 assumptions made by Mr Delamer that underlie the changes
11 that he outlined at paragraph 69(a) to (g) ..."

12 Then it goes on. I do not think there is anything
13 confidential in this yellow.

14 MR WARD: I cannot really help with why it is marked yellow.

15 I do not know why.

16 MR BEARD: I am just going to read it out --

17 MR WARD: Do you mind if I just take instructions?

18 MR BEARD: Yes. (Pause).

19 MR WARD: There is no objection to you reading this part
20 out.

21 MR BEARD: I am most grateful, thank you.

22 It says:

23 "In light of the information contained in BCLP's
24 letter to Travers Smith ... I understand that
25 irrecoverable VAT in respect of both: (i) the purchase

1 price for trucks purchased outright; and (ii) lease
2 charges relating to trucks subject to leasing
3 arrangements would have been accounted for within
4 Royal Mail's accounting systems."

5 So that is just the top of that page.

6 That is all I need to refer to, so we will take it
7 off the screen in case there is anything else further
8 down that is of any concern.

9 In other words, what was being said here was that
10 this was the first you knew, essentially, about how
11 irrecoverable VAT was accounted for by Royal Mail. That
12 is correct, is it not?

13 A. Yes.

14 Q. Now, could we just go to {E/IC19/47}, please? Now, we
15 were just looking at your third report; what this is, at
16 5.19, is Mr Bezant's first report, dated
17 19 November 2021. So several months before the BCLP
18 letter that you have just been referring to in your
19 third report. I will just read 5.19:

20 "I have not been provided with information on the
21 extent to which any irrecoverable VAT costs associated
22 with its Truck purchases (under different procurement
23 methods) have been recorded in the same cost categories
24 as Trucks (or in other cost categories). However, as
25 I explained in Section 6, I have identified evidence

1 that [Royal Mail] incorporated its irrecoverable VAT
2 costs in relation to Trucks procured through finance and
3 operating leases into the internal charges levied on
4 other parts of [Royal Mail]."

5 Now, I do not think we need to go through section 6,
6 but the short point is that Mr Bezant, who is an expert
7 accountant, was able to identify the way in which
8 irrecoverable VAT was accounted for from the underlying
9 materials and you had not, had you?

10 A. No.

11 Q. No.

12 Do you think it was your lack of accounting
13 expertise that was the reason that you were unable to
14 identify this or the fact that you had not studied the
15 underlying documents?

16 A. I think it might be a combination of both.

17 Q. There is one other issue that I want to pick up before
18 I move on. This is a general point. It is right that
19 in your supply pass-on analysis, you proceed on the
20 basis that for trucks purchased outright, around 90% of
21 the cost of the putative overcharge was recognised
22 through depreciation. Is that -- that is the approach
23 you adopt; correct?

24 A. Yes.

25 Q. So 10% you are treating as being recovered through the

1 sale of used trucks; correct?

2 A. Correct.

3 Q. Now, we know from yesterday that your position is that
4 the price of used trucks did not increase as a result of
5 the overcharge, so you say that prices at which
6 Royal Mail sold used trucks would have been the same in
7 the counterfactual; correct?

8 A. Correct.

9 Q. I know it is sometimes said that consistency is the
10 hobgoblin of a small mind, Mr Harvey, but it must
11 follow, must it not, that, on your position, 100% of the
12 putative costs of the overcharge was recognised by
13 Royal Mail as depreciation for the purposes of supply
14 pass-on; yes?

15 A. I do not think so. It depends how they decided to
16 recover the costs through the setting of their own
17 prices and how much was deducted in terms of their
18 anticipated resale value.

19 Q. Well, let us just be clear. On your approach, none of
20 the overcharge was recovered through used trucks;
21 correct?

22 A. Correct.

23 Q. So if on your approach none of the overcharge was
24 recovered through used trucks, surely all of the
25 overcharge you are hypothesising must have come through

1 the depreciation; correct?

2 A. No, it just depends on how they decided to set their
3 prices and the costs that were taken into account when
4 doing it.

5 Q. Let us just be clear. You say that 90% of the cost of
6 the putative overcharge was recognised through
7 depreciation, but for some reason 10% of that overcharge
8 was not?

9 A. Yes.

10 Q. The reason you give -- well, let us go to your third
11 report at 3.13, so {E/IC57/24}. So:

12 "In my First SPO Report, I estimated an assumed
13 anticipated resale value by multiplying the VOC by the
14 weighted average share of the VOC recovered via resale,
15 which I calculated to be 11.7% ...

16 "As set out above, in my updated estimates I use the
17 residual values in Mr Delamer's analysis for operating
18 leases and financing leases. To reflect this, I have
19 updated my calculation of the weighted average share of
20 the VOC recovered via resale so that it includes trucks
21 acquired under outright purchase only.

22 "On the basis of this updated calculation, I find
23 that Royal Mail recovered 10.8% of the VOC through
24 resale of trucks purchased outright."

25 So here, you are talking about the used truck and

1 resale recovery rates; correct?

2 A. Yes.

3 Q. That is the reason, it is those resale and recovery
4 rates that you are referring to when you are talking
5 about why it is that only 90% of the cost of the
6 putative overcharge should be recognised through
7 depreciation; correct?

8 A. Yes.

9 Q. But you say that zero overcharge was passed through into
10 resale; correct?

11 A. Yes.

12 Q. In those circumstances, these calculations in relation
13 to resale are therefore irrelevant to the question of
14 the extent to which the putative overcharge was passed
15 through in relation to SPO -- supply pass-on; correct?

16 A. In terms of the amount that goes through SPO, what
17 matters there is how much of the total truck cost was
18 being considered when setting the prices, and when they
19 were calculating how much of that should be considered
20 when setting the prices, they made a deduction for the
21 amount of money that they would expect to get on the
22 resale value of the truck.

23 Q. I understand that. But your case is, Mr Harvey, that
24 none of the overcharge went through that resale process,
25 so I do not understand why you are saying that this

1 should be a reduction in the amount of overcharge that
2 would be recognised through depreciation, because you
3 are not providing any other route by which these costs
4 could be dealt with, are you?

5 A. Yes. That is not the same as saying all of it would be
6 recognised through depreciation.

7 Q. Well, where is it going then, Mr Harvey?

8 A. Well, it is not getting recovered.

9 Q. It is not getting recovered at all?

10 A. No.

11 Q. That is what you say, and you have no basis for this
12 distinction between 90% and 100%? You just assume that
13 is the case?

14 A. No, that is not right.

15 Q. Well, we will come back to further questions in relation
16 to this in due course. I suggest to you that that is
17 not consistent, but let us move on to the price controls
18 themselves.

19 I am going to actually work backwards to some extent
20 and I am going to focus on Royal Mail. So what I will
21 do is I will focus on PC3 to begin with, that is price
22 control period 3, and I think you are aware that that
23 ran from 2006 to -- April 2006 to March 2012?

24 A. It did. It was in fact divided into three stages: the
25 first stage ran from 2006 to 2010, and then there were

1 two subsequent years where the price control was
2 changed.

3 Q. Well, they were extended, yes. I do not think they were
4 changed. Just for the benefit of the tribunal --

5 A. No, sorry, they were changed.

6 Q. Yes, the degree to which they were changed is something
7 we may need to come back to, but there were certainly
8 two one-year extensions.

9 Now, just for the benefit of the tribunal, the
10 reason why I think focus is drawn on to PC3 is that
11 I think that there is broad agreement that the PC3
12 period is the most important for the supply pass-on
13 analysis in that it accounts for around a third of the
14 putative overcharge. I think there is a broad agreement
15 on that; correct?

16 A. Yes, there is broad agreement on that. Yes.

17 Q. Yes.

18 A. There is broad agreement on the number. Of course, it
19 means that two thirds of the putative overcharge are
20 elsewhere.

21 Q. Yes, I -- I am going to be okay with that maths, yes.

22 A. Good.

23 Q. The next most important period is actually PC2, which
24 I will come -- the reason I am working slightly
25 backwards is because PC2 is about 26/27% of the putative

1 overcharge, is it not?

2 A. Of that one, yes.

3 Q. Yes, so I will come back to PC2 later.

4 Now, some of the points that I am going to pick up,
5 I think we can probably short-circuit because of the
6 answers provided by Mr Jeavons in his testimony. You
7 were in court for Mr Jeavons' testimony; is that right?

8 A. I was not in court for Mr Jeavons --

9 Q. I am sorry, I am misremembered. I am sorry. I know
10 I have asked you that before. But you have read the
11 transcript?

12 A. Yes, I have seen the transcript. Yes.

13 Q. Yes. Okay.

14 A. It would be helpful to go to the transcript if --

15 Q. Sure. I am more than happy to do that, but let us start
16 with a very basic question. PC3, regulatory asset value
17 control, that is what the structure of the control was?

18 A. Correct.

19 Q. Yes.

20 Now, let us go to a document in relation to PC3, the
21 initial proposals. Now, this was a document I showed to
22 Mr Jeavons, if we just go to {I3/381/1}, let us pick it
23 up at page 1 so you can just see the document. You may
24 have it in hard copy, I will double-check. I think
25 tab 6 in your hard copies, Mr Harvey.

1 A. Got it, thanks.

2 Q. Yes, thank you.

3 So this is "2006 Royal Mail Price and Service
4 Quality Review", so that is the long title for what we
5 are calling PC3, "Initial proposals, June 2005".

6 If we can just go through to page 92 {I3/381/92},
7 this is paragraph 7.7, and this is just a general
8 description of the approach, the regulatory value
9 approach. You will see -- as opposed to a cash
10 approach, but you will see, picking it up, the final
11 sentence of the main paragraph:

12 "The effect of this approach [the regulatory value
13 approach] if applied on a single year basis is that the
14 allowed revenues would be set to match the sum of:

15 "operating expenditure;

16 "an allowance for depreciation ...

17 "an allowance for profit."

18 So I think we understand that that is the basic
19 structure of the regulatory value approach that is being
20 adopted here in PC3; correct?

21 A. It is, only this is obviously quite shorthand, and an
22 important part of this is that the price control is
23 being set to match the sum of Postcomm's forecasts of
24 operating expenditure that it thought would be the
25 efficient level of operating expenditure for a company

1 like Royal Mail.

2 Q. Understood. But I think you would agree in principle
3 that under this sort of matching approach, Royal Mail's
4 allowed revenues were intended to match the forecast
5 operating expenditure, plus depreciation allowance on
6 RAB, plus the allowance for profit; yes?

7 A. Yes.

8 Q. It obviously follows, in principle, that if the total of
9 those things was lower, then the allowable revenues
10 under this scheme would be lower, just as a matter of
11 principle?

12 A. No, that does not follow immediately from that. It
13 depends on how the price path was actually set and the
14 extent to which it was rounded or not.

15 Q. Well, let us just go back to the very simple approach
16 here. In principle, what is intended is this matching
17 approach that matches, as you have just agreed, forecast
18 operating expenditure, plus depreciation allowance, plus
19 a profit. Now, if any of those three ingredients are
20 lower, then the allowed revenues would be lower;
21 correct?

22 A. It depends on -- as I said, on whether the price path
23 that is then set by the regulator is sufficiently fine
24 grain to reflect a small change in, in this case,
25 operating expenditure and depreciation.

1 Q. So here you are saying, if the amount of any one of
2 those ingredients was only a tiny amount lower, it may
3 make no difference because it would just be treated as
4 a rounding error; correct?

5 A. Correct.

6 Q. Yes.

7 Just as a terminological issue, when we talk about
8 allowed revenue here, we are talking about the level of
9 revenues permitted under the so-called price caps;
10 correct?

11 A. Correct.

12 Q. Yes.

13 So, again, if you have lower price caps, you have
14 got lower maximum prices; correct?

15 A. Yes.

16 Q. You understand -- were you here for Mr Barnes' evidence?

17 A. No, I was not.

18 Q. Right. He gave evidence that Royal Mail generally
19 priced at the maximum permitted by these caps. Can we
20 go to it? {Day6/19}, please.

21 THE EPE OPERATOR: I do not have the transcript for Day 6
22 because it was in closed session.

23 MR BEARD: Now, I am confident that nothing here said by
24 Mr Barnes is remotely confidential, so I am just going
25 to have to read this to you. I do not think it is in

1 the bundle. I think there is a process being
2 undertaken --

3 THE CHAIRMAN: Do we not have a transcript for Day 6 then?

4 MR BEARD: We do have a transcript for Day 6, but it was
5 only circulated by email and it has not yet made it on
6 to Opus, as I understand it, I think because the
7 transcript section of Opus is not marked as
8 confidential. If you remember, that was the day when we
9 treated the whole session as confidential, and there was
10 a process to then de-redact, but I do not think that has
11 happened yet unfortunately.

12 THE CHAIRMAN: I see.

13 MR BEARD: That is the only reason. I am sorry.

14 THE CHAIRMAN: No, that is fine.

15 MR BEARD: I am just going to pick it up -- I will just give
16 it as notes for the moment and then the tribunal will
17 have versions of the transcript that will have been
18 emailed under the heading "Production" from Opus 2, but
19 we will make sure that both a private and unredacted --
20 or redacted transcripts are provided.

21 THE CHAIRMAN: We did not get them by email actually. We
22 might have done initially, but I am not sure.

23 MR BEARD: Okay. I will follow up with that just as
24 a matter of housekeeping in the short adjournment, but
25 it does not need to hold this up.

1 THE CHAIRMAN: No.

2 MR BEARD: So this is a question from me, I will pick it up
3 just slightly up the page at line 13 {Day6/19:13}:

4 "Question: You here are [Mr Barnes] essentially
5 saying that there was a concern that Royal Mail -- there
6 was a problem that you encountered in PC3 that forecast
7 volumes that dictated the price control in the end did
8 not come to pass. That is the fundamental issue here,
9 is it not?

10 "Answer [from Mr Barnes]: Yes.

11 "Question: So the forecast did not in the end
12 reflect reality. We do not need to argue about whether
13 the forecasts were good, bad or indifferent. They did
14 not pan out."

15 Then, the key part that I wanted to refer to:

16 "What you are saying here is that you could not make
17 up for those lost volumes by increasing prices because
18 there was a cap on the price that you could price up
19 to?"

20 Mr Barnes nods at that point, but it is noted on the
21 transcript. Then a further question:

22 "So what you are saying there, as I think Mr Jeavons
23 has already indicated, was that during the period you
24 want to price absolutely up to the cap but that cap
25 never quite compensated for the volume lost --

1 "Answer: No.

2 "Question: -- or volume shortfall, I should say,
3 that existed; correct?

4 "Answer: No, it did not, and it was a volume
5 shortfall. The letter market went into decline as
6 a result of e-substitution."

7 Then I provided further questions going into these
8 matters.

9 So the evidence that Mr Barnes was providing was
10 that although -- and Mr Jeavons too, was indicating that
11 although there were volume shortfalls, they never made
12 up for the fact -- they were never able to price to
13 a point which compensated for those volume shortfalls.
14 You understand that?

15 A. Yes.

16 Q. So what they wanted to do was generally price up to the
17 maximum permitted by the caps; you understand that?

18 A. Yes, I understand that, based on that. In preparing my
19 report, I refer to various documents that indicate that
20 they did, on occasion, plan to under-recover to pass the
21 independent audit of the price control amongst other
22 things.

23 Q. On occasion? Just checking, I think this is obvious,
24 you did not ask Mr Barnes about whether or not they
25 generally priced up to the caps, did you?

1 A. No, I did not, but I can see from the documents that,
2 when they were setting the tariffs, they considered --

3 Q. Yes, and you did not ask Mr Jeavons about those issues?

4 A. No.

5 Q. No.

6 THE CHAIRMAN: Is it for Mr Harvey to be asking witnesses
7 questions?

8 MR BEARD: Well, these are questions of the enquiry in
9 relation to the issue in relation to supply pass-on, and
10 what matters here is the question of whether or not
11 Royal Mail were generally pricing up to its caps, which
12 is something that Mr Harvey has said, from documentary
13 material, that on occasion they were not. He has just
14 given that evidence.

15 So the point I am making here is that actually he
16 had access to people that could talk to him about these
17 things.

18 THE CHAIRMAN: Did he have access to those people?

19 MR BEARD: I am sorry?

20 THE CHAIRMAN: Did he have access to those people? Have you
21 asked him that?

22 MR BEARD: Yes -- well, I think they are Royal Mail
23 employees, he is acting on behalf of Royal Mail.

24 I think if the expert was being obstructed from access
25 to individuals within the client in order to be able to

1 ask questions, I am sure Mr Harvey would have indicated
2 that.

3 There was no indication of any restriction on your
4 contact with any individuals within Royal Mail at any
5 point, was there?

6 A. No.

7 Q. No.

8 A. Would you like me to show you the documents that I am
9 referring to?

10 Q. No, we will move on in relation to these issues because
11 I wanted to talk further about the price caps. They
12 were set on a RPI minus X basis; that is correct?

13 A. That is correct.

14 Q. Yes.

15 I cannot remember again whether or not you were here
16 for the cross-examination of Mr Nicholson. Were you
17 here during that?

18 A. I heard some of that, but not all of it.

19 Q. Just to remind the tribunal, an RPI minus X basis, that
20 is the same as what Mr Nicholson described as
21 a glidepath control; correct?

22 A. Correct.

23 THE CHAIRMAN: This is BT?

24 MR BEARD: That was BT. I am just putting the two things --

25 I am staying with Royal Mail in relation to the

1 questioning, I am just putting the two things together.
2 RPI minus X and glidepath control are the same things
3 effectively.

4 THE CHAIRMAN: All right.

5 MR BEARD: I was just --

6 THE CHAIRMAN: Just remembering, Mr Nicholson was BT.

7 MR BEARD: Mr Nicholson was BT. I am sorry, I probably
8 should not have asked those questions. I was just
9 tidying up some terminological issues.

10 THE CHAIRMAN: Okay, fine.

11 MR BEARD: No, more than that, sir.

12 THE CHAIRMAN: All right.

13 MR BEARD: I am staying now with Royal Mail.

14 So, under these sorts of mechanisms, the regulator
15 sets the allowed revenues for the first year; correct?

16 A. Yes.

17 Q. In PC3 for Royal Mail, the allowed revenues were the
18 base year costs plus 4%; do you recall that?

19 A. Yes.

20 Q. Yes.

21 Then there is an X factor, which is a percentage
22 number, which determines how much the allowed revenues
23 decrease each year; correct?

24 A. That is correct.

25 Q. Yes.

1 Just while we are thinking particularly about PC3,
2 it is right, is it not, that there were two baskets of
3 products? There was a captive basket, do you recall
4 that?

5 A. Yes.

6 Q. The captive basket included services where the prospects
7 of competition were essentially most weak; is that
8 broadly right?

9 A. Yes.

10 Q. Yes. So you have a captive basket, and then you have
11 a separate X for the non-captive basket; correct?

12 A. Correct.

13 Q. The captive basket X was minus 0.14%; do you recall
14 that?

15 A. Yes. Yes, it was. Yes.

16 Q. For the non-captive basket, it was minus 1.96%; correct?

17 A. Correct.

18 Q. So X was set essentially to the nearest second decimal
19 place percentage?

20 A. That is correct.

21 Q. Yes.

22 Just -- I think this is common ground, but a 0.01%
23 change in the level of X would equate to around
24 0.7 million of allowed revenue; do you recall that
25 maths?

- 1 A. Yes, I do. Yes.
- 2 Q. One point that has been raised on a number of occasions
3 is that the overcharge that you are positing is actually
4 a small proportion of Royal Mail's overall costs, but
5 I think you recognise that one of the key things that we
6 are actually interested in for supply pass-on is whether
7 the overcharge would have shifted the price caps;
8 correct?
- 9 A. Yes, that is why I am interested in the size of the
10 overcharge.
- 11 Q. Yes. So that requires careful analysis of how the
12 regulatory regime operates rather than just an overall
13 comparison of overcharge to costs; correct?
- 14 A. It does, in terms of working out whether or not the X
15 factor would change. The size of the overcharge is
16 relevant though for considering the extent to which
17 forecasts and so forth would have been fine-tuned to
18 overcharges of that size.
- 19 Q. We will come back to that, but I think you have
20 recognised that what Postcomm was doing, after
21 interrogating all of that information, was setting
22 a price cap involving an X which was rounded to the
23 closest 0.7 million of revenue; that is correct, is it
24 not?
- 25 A. Yes.

1 Q. Yes.

2 Now, the second point I wanted to pick up in
3 relation to price caps was in relation to the profit
4 allowance component. Now, the profit allowance
5 component means that for every pound that is forecast,
6 included in the forecast regulatory asset base, you
7 would get a pound more of allowed revenue; correct?

8 A. That is correct. It is to remunerate the cost of
9 raising finance for the asset, yes.

10 Q. In fact, you get more than a pound of allowed revenue;
11 that is correct, is it not?

12 A. Yes.

13 Q. Yes.

14 I do not think this is contentious, but in the
15 context of PC3, for each profit allowance pound, you
16 would actually get -- sorry. For each initial pound of
17 forecast regulatory asset base, so capital expenditure
18 for example, the profit allowance would be 140% of that
19 pound; correct?

20 A. I cannot remember the figures actually, in terms of what
21 that would work out at. I think there was some
22 discussion over the precise calculation.

23 Q. Well, I can take you to Mr Bezant's first report, so
24 that is {E/IC19/100}. Do you recall this?

25 A. Yes.

1 Q. Now, as far as we can identify, you have not challenged
2 the figure of 140% that is calculated using this table
3 in any of your reports. Are you saying that is not
4 correct?

5 A. I think there were some issues that we raised actually,
6 but I cannot remember what figure I arrived at.

7 Q. Well, we will have to check that. But you recognise,
8 I think, that the profit allowance will be an amount
9 above the pound included in the forecast regulatory
10 asset base?

11 A. Yes.

12 Q. Yes.

13 MR RIDYARD: Mr Beard?

14 MR BEARD: Yes?

15 MR RIDYARD: For my benefit, can you explain, when you say
16 "the profit allowance", that is not just the revenue
17 allowance, that is something different from that, is it?

18 MR BEARD: So I was really just using the language actually
19 that I had had from the three categories when I was
20 referring to the initial proposal. I was just trying to
21 use consistent language. If you remember, there is an
22 allowance for profit, which is a profit allowance that
23 is applied to the regulatory asset base. So I do not
24 think that that is different from the revenue allowance.
25 What I was pointing to was the difference between

1 operating expenditure, the allowance for depreciation,
2 and then essentially being entitled to earn a profit on
3 the relevant regulatory asset base. But I think that
4 could be referred to by either terminology. I was just
5 trying to use --

6 MR RIDYARD: By either profit or revenue?

7 MR BEARD: Well, sorry, the overall allowed revenue will be
8 made up of that, and therefore this is an allowance for
9 profit that then goes into the total of allowed revenue,
10 based on those three components that were set out in
11 the -- I am sorry, I am not sure I am answering the
12 question properly.

13 THE CHAIRMAN: Is this the margin -- profit is the allowable
14 margin there?

15 MR BEARD: Yes, that is exactly right. It is the allowable
16 margin that contributes to the revenues. I am sorry --

17 MR RIDYARD: So for every -- every extra -- just to bring it
18 back to the base, for every extra pound of cost, capital
19 expenditure --

20 MR BEARD: That is admitted into the forecast RAB, yes.

21 MR RIDYARD: Yes. You get £140 of, what? Of revenue
22 allowance?

23 MR BEARD: You get £140 of allowance for profit effectively.

24 MR RIDYARD: No, that is what I do not understand though.
25 Maybe it is unfair to --

1 MR BEARD: 140 pence, I am sorry, it would be, but yes.

2 MR RIDYARD: Yes. Yes. Yes.

3 MR BEARD: I am so sorry, I do not understand.

4 MR RIDYARD: Okay. We will follow that up maybe later.

5 Sorry.

6 MR BEARD: I think this is to do with the figures that are
7 then used -- I think at this time, a weighted average
8 cost of capital approach to allow profit was included
9 and that that allowed effectively an uplift in relation
10 to the amount of permitted profit. Sorry.

11 SIR IAIN MCMILLAN: Yes. Very quickly, Mr Beard, 140%, is
12 that the allowable return on capital employed?

13 MR BEARD: I am concerned about using the term "return on
14 capital employed" because it is the forecast regulatory
15 asset base that is the basis for this, but it is akin to
16 that process in relation to other commercial approaches.
17 In other words, what is being done in the regulatory
18 scheme is that a forecast is being made of the relevant
19 regulatory asset base and a return on that regulatory
20 asset base is being permitted by the regulator, and that
21 is why, effectively, you are being allowed these
22 amounts, but Mr Harvey may want to comment on this.

23 A. Right. We can -- putting to one side the difference --
24 any differences on the figures. The table kind of
25 breaks it down I think. So the 140 I think that

1 Mr Beard is referring to at the bottom of the "Annual
2 revenue" column, that is I think the total of both the
3 recovery of the capital cost of the asset, so the sum of
4 the depreciation charges, plus the profit allowance --

5 Q. That is absolutely right.

6 A. So the 140 is not profit, the profit allowance, it is
7 the combination of the recovery of the truck cost, in
8 this example, and an amount that is given to allow the
9 company to cover its cost of capital.

10 SIR IAIN MCMILLAN: Thank you.

11 MR BEARD: Yes. That is absolutely correct. I am sorry.

12 What I did not explain properly was the role of the
13 depreciation recovery in relation to that table, and
14 therefore that is why it is akin to the process that
15 Sir Iain is referring to.

16 A. The second point is, it is -- although it is -- I think
17 Postcomm refer to profit allowance and the cost of
18 capital sort of interchangeably, this should not be seen
19 as a premium over and above the cost of capital.

20 Q. No, I am not intending to suggest that.

21 A. I was not suggesting you were.

22 Q. Thank you.

23 So the third point I wanted to take you to, but
24 I perhaps do not need to, just to remind the tribunal
25 that Mr Jeavons confirmed that it was important for

1 Royal Mail that all of Royal Mail's costs were taken
2 into account given the way that the regulatory regime
3 worked. Do you recall that or do you want me to take
4 you to that passage in his transcript?

5 A. No, you can take me to it, please.

6 Q. Sorry?

7 A. Take me to the passage.

8 Q. {Day4/32}, please. Picking it up at line 9 {Day4/32:9}:

9 "Of course, what that means is that it would always
10 be in Royal Mail's interests to ensure that all of its
11 costs were taken into account, because, in principle,
12 given that objective ..."

13 So the objective of recovering their costs and
14 obtaining a return on the costs included:

15 "... in principle, given that objective, the higher
16 costs taken into account, the higher level of allowed
17 revenues; that is correct, is it not?

18 "Well, I mean, you know, the regulatory construct is
19 one that, you know ..."

20 He caviled at the idea of regulatory gaming, which
21 I said I was not suggesting Royal Mail was engaged in.

22 If we move down to line 24 {Day4/32:24}:

23 "I was not suggesting it was a game. I was
24 suggesting that it was important to ensure that all of
25 your costs were taken into account because of the way

1 that you knew Postcomm was seeking to regulate you; that
2 is correct, is it not?

3 "That is correct, yes."

4 So he is just confirming there that, so far as
5 Royal Mail was concerned, because of the nature of the
6 regulatory scheme, it was important that all of the
7 costs that Royal Mail had were taken into account in
8 that scheme; you understand that?

9 A. Yes, but of course it cannot guarantee that in this
10 price control process because it knows its costs at the
11 time of setting the price control, and what the
12 regulator has to do is to decide what its costs are
13 going to be on a forward-looking basis, as does
14 Royal Mail. So I accept that that is what he wants to
15 happen.

16 Q. Yes, that is exactly what he wants to happen and that is
17 what Royal Mail is trying to do by putting forward all
18 of its costs.

19 I am going to move on to a new topic in relation to
20 the PC3.

21 I do not know -- I am assuming we want to do two
22 breaks this morning; is that sensible?

23 THE CHAIRMAN: Well, we can either do two breaks or one
24 longer break.

25 MR BEARD: I am happy to carry on depending on whether

1 Mr Harvey would prefer two, or one break.

2 If you would like --

3 A. I would prefer one break I think, let us carry on.

4 THE CHAIRMAN: Maybe we will take it around 11.30 then,
5 a 15-minute break.

6 MR BEARD: Yes, absolutely.

7 So let us move on and pick up a couple of points on
8 the opening value of the regulatory asset base, where
9 I think your evidence may, to some extent, have been
10 overtaken by the evidence of Mr Jeavons.

11 If we can just go to the joint statement at
12 {E/IC83/53}. The row in the joint statement that is
13 relevant I think is G.5.6, "Determination of
14 Royal Mail's opening [value of the] RAB". Do you see
15 that?

16 A. Yes.

17 Q. Yes.

18 Now, the estimate of the RAB included 47 million in
19 assets for owned vehicles, which I think you refer to in
20 your contribution to the joint statement; correct?

21 A. Yes.

22 Q. So you accept that the opening value of the RAB included
23 the value of vehicles owned by Royal Mail; correct?

24 A. Yes.

25 Q. Then, in G.5.7, I think you accept the basic accounting

1 point that trucks that Royal Mail had purchased outright
2 or using financing leases, rather than operating leases,
3 were on Royal Mail's balance sheet, which we have
4 touched on before; correct?

5 A. Yes.

6 Q. Yes.

7 So those trucks -- all of those trucks would have
8 been included within the 47 million for owned vehicles
9 within the RAB; correct?

10 A. Yes.

11 Q. Just thinking about the steps in the supply pass-on
12 analysis, we can agree, I think, then that it is likely
13 that the opening value of the RAB that Postcomm had
14 regard to when it was setting the price caps included
15 the trucks already purchased by Royal Mail; correct?

16 A. Yes.

17 Q. Yes.

18 Then, in G.5.8, you say it is "highly uncertain"
19 that the opening RAB would have been lower absent the
20 putative overcharge. You say that because this depends
21 on the specifics of how any trucks were valued and
22 whether those valuations would have differed absent the
23 overcharge.

24 Now, I think it is clear you did not ask anyone at
25 Royal Mail about how trucks were valued for the purposes

1 of submission to the opening RAB, did you?

2 A. No, I did not.

3 Q. No.

4 Could we just go to Postcomm initial proposals table
5 again? This is {I3/381} and this time at page 105
6 {I3/381/105}. It is back in tab 6 in your hard copy,
7 Mr Harvey. Have you seen this table before?

8 A. Probably, yes.

9 Q. Probably, yes. I see.

10 Now, it says at the top that these are values for
11 tangible assets as of 31 March 2006, but I do not think
12 there is any disagreement it should actually
13 be March 2004.

14 You see the third column, so you have got three
15 columns, "Asset class", "HCA value ...", so that is the
16 historic cost accounting value, then you have got
17 "CCA ..." which is the current cost accounting value,
18 and then you have got "Valuation for CCA methodology",
19 fourth column, do you see that?

20 A. Yes.

21 Q. If we look down the third column for vehicles, that is
22 where we see the 47 million, CCA figure for the
23 "Vehicles". Do you see that?

24 A. Yes.

25 Q. So the current cost accounting value of an asset is

1 essentially the current market value of that asset, in
2 other words how much it would cost to obtain an
3 identical replacement; yes?

4 A. Yes.

5 Q. Yes.

6 You will see in the last column there that the
7 valuation for CCA methodology is set out:

8 "Indexed historical cost using asset specific price
9 indices."

10 So we know from that, do we not, that the
11 calculation involved identifying the historical cost of
12 the relevant vehicles and then indexing up according to
13 the relevant price index; correct?

14 A. Yes.

15 Q. Yes.

16 We know that historical cost accounting involves
17 looking at the actual amount of money paid for the asset
18 adjusted for depreciation; correct?

19 A. Yes.

20 Q. Yes.

21 There was a specific commercial vehicles price
22 index, you know that as well?

23 A. Yes.

24 Q. So, if the historical purchase price included the
25 putative overcharge, the current cost accounting value

1 is obviously going to be higher than it otherwise would
2 have been; correct?

3 A. No, it depends on how the price index is calculated.

4 Q. I am sorry, how the price index is calculated? So the
5 index historical cost using an asset specific price
6 index, you are saying the price index could vary?

7 A. I am saying that one way of calculating a price index
8 would be to reach a broad view on the cost of a vehicle
9 at the time of the valuation that would be the
10 replacement cost, and then to uprate with that. If that
11 does not move, then it will not affect the overcharge.

12 Q. Let us just pause there. Your position in G.5.8 is you
13 say it is highly uncertain that the opening RAB would
14 have been lower absent the putative overcharge.

15 A. Yes.

16 Q. We are focusing here on these truck values and we have
17 here clearly set out a method for calculating the
18 current cost accounting value of the vehicle using
19 a particular index, which is setting out actually very
20 clearly how the historical cost accounting value feeds
21 through into the current cost accounting value. But you
22 are saying that it nonetheless is highly uncertain that
23 if the CCA value is included in the RAB, it is unclear
24 that it would have been lower absent the overcharge.
25 Really?

- 1 A. Yes, I am.
- 2 Q. You have no basis for that, Mr Harvey, do you?
- 3 A. Well, I have, because I have got no information about
4 how the price index was calculated. What I know is that
5 they departed from the historic cost of the vehicle and
6 updated it to reflect some view of what it would cost to
7 replace now, and it depends on how they did that.
- 8 Q. Mr Harvey, there is no indication that the price index
9 that was used would change as between a situation where
10 there was a putative overcharge and where there was not,
11 is there?
- 12 A. No.
- 13 Q. No. So you can have the same index being used whether
14 or not there was a putative overcharge; correct?
- 15 A. No, that is what I am saying. I cannot tell from the
16 document.
- 17 Q. You cannot tell from the document whether or not the
18 index used would be different if there were a putative
19 overcharge, and you have no basis for that, do you?
- 20 A. I am saying -- that is why I am saying it is highly
21 uncertain whether the number would be different.
- 22 Q. But, Mr Harvey, the whole idea about your putative
23 overcharge is that no one would know that it was an
24 overcharge; it would just be an additional level of
25 price for the relevant truck?

- 1 A. That is right.
- 2 Q. Yet you are saying that a different index would be used
3 because of that different level of price, even though
4 no one knew that it was in fact driven by an overcharge;
5 correct?
- 6 A. I am saying that no doubt the same index in broad terms
7 would have been used. What matters is the numbers that
8 were inherent in it.
- 9 Q. Let us just go to {I4/199/17}, please.
- 10 A. Which tab is it, Mr Beard?
- 11 Q. I do not think you have got it in the bundle. We can go
12 to the very first page if that is helpful rather than
13 page 17, so you can see what it is {I4/199/1}. This is:
14 "Royal Mail Group Ltd.
15 "An overview of the principles and methodologies
16 used in preparing regulatory financial statements for
17 2007."
18 So this is a general approach that is adopted. Now,
19 I am guessing, given your answers so far, you have not
20 looked at this?
- 21 A. I cannot remember.
- 22 Q. If we go back to page 17 {I4/199/17}, it says:
23 "Additional disclosures.
24 "Regulatory Asset Base -- Basic principles".
25 You will see "Start Point", "Constituents of RAB".

1 Then you will see "Royal Mail Group accounting
2 policies".

3 Then, if we go down the page, to 4.2.1:

4 "Regulatory asset base -- April 2006 starting
5 position.

6 "Non-property assets."

7 Then you will see there:

8 "Royal Mail Group Ltd fixed assets are analysed as
9 part of the annual Regulatory Accounts. For
10 non-property assets, the historic cost net book value
11 balances reported in the 2005-06 Regulatory Accounts as
12 being allocated to the Mails area have been used as the
13 starting points, with the following exceptions."

14 Then there are certain exceptions. If we go over to
15 the top of the next page {I4/199/18}, you will see:

16 "These historic cost values have been uplifted to
17 a Current Cost Accounting valuation using the MM17
18 tables published by the [ONS] as follows:

19 "Vehicles ...

20 "Table number ..."

21 So what is being said here, in Royal Mail's own
22 material, is that you use an ONS index in order to carry
23 out this calculation of the CCA and there is no reason
24 to consider that in a world where there is a putative
25 overcharge, somehow a different index would be used, is

1 there?

2 A. No, that is right.

3 Q. So actually, your proposition that it is all highly
4 uncertain is just not correct, is it?

5 A. Provided that this index was taken into the --
6 Postcomm's assessment, then, no, this would suggest that
7 the vehicles would be updated and that those figures
8 would be inflated with the overcharge, yes.

9 Q. Well, okay. {I1/427/12}, please. Let us pick it up at
10 page 1 {I1/427/1}, because you do not have this in the
11 bundle and I will show you the document. So this is:

12 "Requirement to furnish information to Postcomm
13 under Licence Condition ... made.... 2005."

14 This is a September 2005 document. Let us just have
15 a look. Page 12 {I1/427/12}, and I think we just need
16 to scroll down because there is a little table there.
17 If we could go further down and blow that table up, that
18 is fabulous, thank you.

19 "Postcomm's request: 'further details of the
20 indexation calculation for Plant and Machinery. This is
21 required as it has not been possible with the
22 information provided to date to replicate Royal Mail's
23 given HC and index values' ...

24 "Royal Mail's response: the indexation of MM17... "

25 That is the ONS index that we have just seen, you

1 understand that?

2 A. Yes.

3 Q. "... is set out in the file 'MM17... The calculation is
4 set out below."

5 If you look, in the third row down, you can just
6 about read "Motor vehicles". You can see the second
7 column, it says "[Regulatory] accounts, 45", then
8 "Commercial Vehicles", "Assessed Average Age",
9 "March 2004 Index value", "[Price] Index value", and
10 "Difference". You will see there, just before the
11 "Difference", "Revalued, 47.05 [million]".

12 So what we see here is not only consistency in the
13 approach that is being adopted, but Postcomm saying,
14 "Look, we just want to understand how these figures
15 work", and Royal Mail reverting and working through the
16 indexing mechanism.

17 Now, again, there is no basis, Mr Harvey, for you
18 suggesting that somehow the way in which these numbers
19 would be dealt with, if they were, on your case,
20 slightly higher because of a putative overcharge, would
21 somehow change the index used or Postcomm's approach to
22 these matters or certainly Royal Mail's approach to
23 these matters, is there?

24 A. No.

25 Q. No.

1 One final point I think before we leave the opening
2 RAB. We have discussed the Royal Mail and I think LECG
3 valuation of existing vehicles as at 2004, the
4 historical cost plus indexation using the commercial
5 vehicles index. There is some disagreement between you
6 and Mr Bezant about the indexation subsequently applied,
7 but I think we have now dealt with all of those points.

8 There are two points in relation to Mr Bezant's
9 report I do just want to pick up. Can we go to his
10 first report at {E/IC25/142}? Here, we have got --
11 actually, perhaps we should just scroll up so we can see
12 what this section is, for my benefit and the benefit of
13 the tribunal. Here we are, 16 {E/IC25/141}, thank you
14 very much, "2006-12 PC3 Period: My estimate of
15 illustrative effects of Trucks included in the RAB".
16 There is an introduction. If we could go down to 16.7
17 {E/IC25/142}:

18 "Below, I explain the assumptions I adopt ...

19 "16.7. To calculate the RAB from the invoice year
20 to 2005 ... I apply an inflation rate based on the
21 actual RPI."

22 Then there is a footnote.

23 Then:

24 "16.8. To calculate the RAB in each year from 2005
25 ... to ... 2012, I apply an inflation rate of 2.5%, the

1 rate which Postcomm adopted in its determination."

2 So another footnote, 265.

3 If we could just go down to the footnotes. Thanks.

4 264:

5 "Postcomm applied an inflation rate based on asset
6 specific price index up to 2004/05 ... 7.1 and 7.2 ...
7 For simplicity, I apply an inflation rate based on the
8 general RPI. My conclusions are not sensitive to this
9 assumption."

10 Now, just to be clear, are you saying that this is
11 an unreasonable assumption that Mr Bezzant has adopted
12 here?

13 A. Which parts of my report are you referring to, sorry,
14 Mr Beard?

15 Q. Your reply report, we can go to it, {E/29/65},
16 paragraph 7.22(b). I am not going to read it out, if
17 you ... feel free to read it yourself. (Pause).

18 A. Yes, I have read it.

19 Q. You have read it.

20 So you will see there that, implicitly what you are
21 doing is you are criticising these footnotes that he --
22 the assumptions he has set out in these footnotes;
23 correct?

24 A. Yes.

25 Q. Yes.

1 That is why I was asking you why you suggest that
2 this is somehow an unreasonable assumption.

3 Are you saying it is an unreasonable assumption
4 because Postcomm would have just used the 2004 value and
5 not made any further adjustment despite the passage of
6 two years?

7 A. My first report said that it was uncertain about how
8 those assets were revalued and how they were revalued,
9 and there was no information to suggest they would have
10 been revalued on the basis of RPI. That is the basis of
11 the critique.

12 Q. You would expect, would you not, that assets would be
13 revalued to account for inflation just under normal
14 accountancy principles, Mr Harvey, would you not?

15 A. I am not sure I would.

16 Q. You are not sure you would. Well, perhaps that is
17 a question to go to an accountant.

18 Now, the next one is the second footnote, if we
19 could go back to that {E/IC25/142}. This is the
20 revaluation from 2006, so this is 265:

21 "Postcomm updated its calculation of the RAB in each
22 year using actual RPI. My conclusions are not sensitive
23 to using the estimated inflation rate."

24 So Mr Bezant is actually referring there to PC3
25 initial proposals at 7.75, so let us go to that.

1 {I3/381/110}. If we can just scroll down, please, to
2 7.75, "Initial proposals", "Rolling forward the RAB":

3 "To set the allowed revenue for Royal Mail for the
4 initial proposals, Postcomm has rolled forward annually
5 the opening value for the regulated asset base ... by
6 adding estimates of capital expenditure and annual
7 inflation, and deducting estimates of depreciation (on
8 a MEAV basis) and disposals. Capital expenditure has
9 been added consistent with the projections made by LECG,
10 which are discussed in Chapter 8 and its report. Annual
11 inflation [if we go over the page {I3/381/111}] has been
12 added, assuming an estimate of inflation of 2.5%.
13 Estimates of depreciation have been deducted on
14 a straight line basis ..."

15 Now, you would accept, I think, looking at this
16 now -- you may not have looked at before, but you would
17 accept now Mr Bezant's approach to inflation from 2006
18 is exactly in line with what Postcomm indicated it would
19 do, is it not?

20 A. Yes.

21 MR BEARD: Yes.

22 I am conscious of the time.

23 THE CHAIRMAN: Is that a good time for a break?

24 MR BEARD: Yes.

25 THE CHAIRMAN: All right. We will have a quarter of an hour

1 break.

2 (11.31 am)

3 (A short break)

4 (11.48 am)

5 MR BEARD: I am going to move on to the forecast RAB and
6 PC3, but before I do that, I just wanted to pick up
7 something that you said earlier about the 140% of
8 initial capital expenditure being effectively allowed
9 revenue, where I think my answer was fantastically
10 garbled but I think I got there in the end in terms of
11 what the 140% stands for.

12 But you, Mr Harvey, said:

13 "No, there are some issues I take with 140%."

14 I think, just briefly looking back at your report,
15 I think you agree with the approach, the mathematical
16 approach to 140%, but you disagree with a number of
17 assumptions that Mr Bezant has made in reaching that
18 140%. I think you come up with 126%; is that right?

19 A. That is right, yes.

20 Q. Yes.

21 We disagree about those assumptions, but they will
22 no doubt be put to Mr Bezant in due course. But yours
23 is 126% rather than 140%?

24 A. Yes, it is.

25 Q. Thank you.

1 Let us go then to the forecast RAB for PC3. So we
2 are going to focus on forecast capital expenditure
3 first, and we can probably short-cut this a little by
4 reference to Mr Jeavons, I hope. He gave evidence about
5 Royal Mail's vehicle procurement in relation to PC3 and
6 specifically Royal Mail's initiative to shift from
7 purchasing all vehicles rather than leasing them.
8 Do you recall that?

9 A. Yes.

10 Q. Yes.

11 It may be useful if we just briefly go to the LECG
12 report that refers to the numbers, so could we go to
13 {I3/391/1}, please? Page 1 so that you can see what the
14 document is. I do not know if you have it in hard copy,
15 I will just check. Tab 9 perhaps?

16 A. Yes, got it.

17 Q. Right. Tab 9. So you see this is the LECG
18 report, February 2006, so part of the analysis being
19 carried out in setting the PC3 price control?

20 A. Yes.

21 Q. Yes. You are aware of that.

22 So if we can just go to page 143, please
23 {I3/391/143}, you will see there paragraph 9.52,
24 "Vehicle procurement policy". There, you see the
25 description of the change in approach from Royal Mail.

1 Do you see that?

2 A. Yes.

3 Q. If you want to just read through that. Then, table 85,
4 you will see at the bottom, shows opex savings and capex
5 costs. You will see in that table that Royal Mail's
6 projected capex costs were 484 million for the relevant
7 period?

8 A. Yes, that is right.

9 Q. Do you see that?

10 Now, I want to just look at the underlying document
11 that generated those figures, so could we go to
12 {I6/233}, tab 1 in your hard copy bundle. Thank you to
13 Ms Mackersie.

14 This is a document that I showed to Mr Jeavons.
15 This is Royal Mail's vehicle procurement policy. Do you
16 remember seeing this?

17 A. Yes.

18 Q. Have you seen this?

19 A. Yes, I think I have, yes.

20 Q. You think you have. Are you sure?

21 A. No, I am not sure.

22 Q. You are not sure, okay. Let me take you through it.
23 Vehicle procurement policy, it is in pounds millions,
24 2005/2006. "Description and expected impact":

25 "The current planning assumption agreed by

1 RM Finance is to move to 100% vehicle ownership as
2 historical leasing contracts expire ..."

3 So this is the shift that we were talking about.

4 "However, this decision is reviewed on a quarterly
5 basis and it is possible that leasing options become
6 more favourable over the planning period. This policy
7 should be viewed as 'business as usual' rather than
8 a 'one-off' project."

9 Then, if we see on the left-hand side, it says
10 "Capex Required", and then you have got the various
11 years and you have got the sums in millions. Do you see
12 that? 160, and then 108, 108, 108, 160, and it is those
13 four years that provided the basis for the LECG figures.

14 A. Yes.

15 Q. Yes.

16 So what we have here is a document that has been
17 prepared -- so just looking at the "Analyses carried out
18 to support investment":

19 "Assessment of costs:

20 "Gathered recent historical price quotes from
21 leasing panel and procurement.

22 "Gathered historical data on residual values and
23 extraneous charges ..."

24 Then, looked at:

25 "Assessment of obligations ...

1 "Evaluation of lease/purchase options ...

2 "[Estimate] of capex and benefits ..."

3 So clearly there had been quite a substantial
4 exercise undertaken by Royal Mail to produce these
5 figures. You understand that?

6 A. Yes.

7 Q. I think Mr Jeavons referred to it as a sophisticated
8 analysis.

9 A. It is hard to tell, obviously, from this document
10 exactly the extent to which -- how detailed that
11 analysis was and exactly what historical data was used
12 and what it means by "based on" and so forth, so it
13 is ...

14 Q. Well, he concurred that it was a sophisticated analysis
15 so ...

16 A. Okay.

17 Q. You say that Postcomm did not explicitly consider the
18 overcharge or truck costs when forecasting, but here we
19 are talking about truck costs, whatever they might have
20 been, are we not?

21 A. Yes.

22 Q. So in terms of our outline of the stages of the supply
23 pass-on analysis, it is likely then that the truck costs
24 were included in Royal Mail's forecast capital
25 expenditure, is it not?

- 1 A. It depends on what "based on historical price quotes"
2 means.
- 3 Q. Sorry, their forecast truck costs were based on this
4 kind of analysis and you are saying that these truck
5 costs were not included in Royal Mail's forecast capital
6 expenditure?
- 7 A. No, no, they are included in Royal Mail's capital
8 expenditure.
- 9 Q. Yes.
- 10 A. What I am questioning is the level at which they are
11 included. I cannot tell that from the document and the
12 extent to which that relates to the actual prices paid.
- 13 Q. Right. I have just taken you to the LECG document which
14 was LECG consulting for Postcomm, was it not?
- 15 A. Yes.
- 16 Q. What we have seen is that Postcomm and LECG have taken
17 these figures that are provided by Royal Mail, have they
18 not?
- 19 A. Yes.
- 20 Q. Yes.
- 21 So these truck costs that have been analysed by
22 Royal Mail and put into forecast capital expenditure,
23 those have been adopted by LECG in the process with
24 Postcomm; correct?
- 25 A. Well, they make various adjustments to the figures

1 before adopting them and including them in the price
2 control.

3 Q. They do make amendments -- or adjustments to them, that
4 is absolutely right. But the adjustments they make to
5 them, there is no reason to think those adjustments
6 would be different in the counterfactual, is there?

7 A. If we look at table 86, which is on page {I3/391/144},
8 my understanding is the row that says "Capex" is the row
9 that is included as capex in the end in the price
10 control.

11 Q. That is absolutely correct, they are reduced capex
12 figures, but none of the adjustments are to remove
13 trucks which reduce the quotes, are they?

14 A. If you look at the figures though, when I look at this
15 table, I see four columns that have rounded 95, 95, 95,
16 95 figures in them, and they look remarkably different
17 to the sort of rather unrounded figures that were
18 presented by Royal Mail. I suppose that it is possible
19 that in the calculation of the figures, they reached
20 a sort of a rounded view on the overall expenditure that
21 Royal Mail need to make on vehicles. But that rounding
22 is significant, I think, because, as we have discussed
23 in this period, the overcharge was around 7 million and,
24 looking at each of those figures, if they are rounded to
25 the nearest 5, then actually it is quite possible those

1 rounded figures would not have changed. The bit of the
2 puzzle that is missing is exactly what happened in
3 between the figures that Royal Mail provided and the
4 figures that LECG calculated.

5 Q. Right. Just to be clear, you do not just have capex,
6 but you have opex figures here, do you not?

7 A. Yes.

8 Q. They are not rounded to the nearest 5, are they?

9 A. No.

10 Q. No. So if we just go back up to 9.53 if we could,
11 please {I3/391/143}, so here we have table 85, and then
12 it says:

13 "We would expect that any change in policy would be
14 value-creating for Royal Mail. As such, we would expect
15 total costs to fall in the long run, which would be
16 reflected in the resulting revenue requirement for
17 Royal Mail being slightly lower as a result. However,
18 based on the numbers presented by Royal Mail, we
19 estimate a significant increase in total costs on an NPV
20 basis, and an associated higher revenue requirement.

21 "We shared this observation with Royal Mail and
22 challenged them to support the financial dynamics of
23 this initiative. Despite repeated requests, Royal Mail
24 provided very limited detail in relation to this
25 initiative, and failed to provide a quantitative

1 comparison of the various policy options. In its
2 Strategic Plan, Royal Mail states that it is not an aim
3 of this initiative ... to fund an increase in overall
4 vehicle capacity.

5 "Based on the data provided to us on historical
6 lease payments, and on new capital expenditure
7 requirements, we estimated the point at which the two
8 options were financially equivalent, in terms of revenue
9 requirement in net present value terms. This implied
10 a reduction in Royal Mail's planned capital
11 expenditure."

12 So what LECG is doing -- sorry {I3/391/144}:

13 "Based on our analysis, we have adjusted Royal Mail
14 capital expenditure as follows."

15 That is when you get to table 86.

16 So when you say, "Oh, look, these look like rounded
17 figures", actually what LECG is explaining is not that
18 they are rounding figures differently, they are actually
19 carrying out a very acute and precise analysis using
20 historical lease payment data and calculating, pretty
21 exactly, what they think that means in terms of a change
22 in capital expenditure. So your account which says,
23 "Oh, look, there is just a lot of rounding going on" is
24 not borne out by the process articulated here, is it?

25 A. It is borne out by what I see in the table. In terms of

1 the process that you have just articulated, it says
2 "based on the data provided", so it is on historical
3 lease payments, and on new expenditure requirements, and
4 they estimated the point at which they were financially
5 equivalent. So there is a lot going on inside this
6 calculation that we just cannot see. What we do know is
7 that they departed from the figures that were provided
8 to them by Royal Mail.

9 Q. Well, they departed from the figures that were put to
10 them by Royal Mail in relation to the capital
11 expenditure forecast. What they then did was took the
12 data from Royal Mail, in relation to both leasing and in
13 relation to the new capital expenditure requirements
14 that had been provided by Royal Mail, and then
15 calculated the point at which the two options were
16 financially equivalent.

17 So they are carrying out a mathematical assessment
18 using the material that has been provided by Royal Mail.
19 They are not carrying out some sort of rounding
20 exercise, are they, Mr Harvey?

21 A. Well, it is remarkable that they arrive at capital
22 expenditure of precisely 95 in every year. I think --

23 Q. You say it is remarkable, but even if it were to be the
24 case that the capital expenditure had been smoothed
25 across the period, that does not mean that there is

1 general rounding, does it?

2 A. No, it does not of itself.

3 Q. No.

4 Just playing this out in the counterfactual, in the
5 counterfactual, assuming some notional hypothetical
6 overcharge, you would have lower historic lease payments
7 and lower projected capital expenditure; correct?

8 A. Yes.

9 Q. There is no reason to think, is there, that Postcomm
10 would not have pursued the same policy of making the two
11 options financially equivalent in net present value
12 terms, would you?

13 A. No.

14 Q. So it would follow, would it not, that the forecast
15 capital expenditure on vehicles would have been lower in
16 the counterfactual, would it not?

17 A. No, that does not follow for the reasons I have given.

18 Q. Well, I say -- I put the case that it is clear that
19 actually your story, in relation to rounding focuses on
20 a list of figures when 95 is used in table 86, ignores
21 the analysis that has been carried out here and fails to
22 reflect the extent of the exercise carried out by
23 Royal Mail in relation to a document that you are not
24 sure you even saw.

25 I have put the case in relation to it, I am going to

1 move on.

2 Depreciation of the RAB. There is just I think one
3 point I need to pick up about the depreciation
4 allowance. Could we go to your third report at
5 paragraph 7.18, that is {E/IC57/56}. I am picking it
6 up, it is part way through a conversation between you
7 and Mr Bezant effectively. Sorry, do you have it?

8 A. Bear with me.

9 Q. Yes. No, sure. So:

10 "This is not my view [is the disagreement with
11 Mr Bezant]. I said that it is 'unclear how the
12 allowances determined by Postcomm would have differed
13 (if at all)' ... To clarify, by this I mean that it is
14 unclear by how much Postcomm's allowances would have
15 differed (if at all). This depends on the depreciation
16 profile that Postcomm assumed, but I have not seen in
17 any Postcomm or LECG document discussion of how assets
18 included in the RAB were appreciated over the period,
19 and Mr Bezant does not refer to any either. For
20 example, I do not know what depreciation profile was
21 used, or if different assets were treated differently.
22 Mr Bezant notes that I have been able to estimate the
23 accounting depreciation in each year resulting from the
24 trucks in Royal Mail's claim."

25 Could we just go back to the Postcomm initial

1 proposals document that we saw earlier, which is
2 {I3/381/110}.

3 Now, we looked at this in relation to the inflation
4 assumptions that Mr Bezant had used in footnotes 264 and
5 265. If you look at paragraph 7.75 "Rolling forward the
6 RAB", if we could just go down over the page
7 {I3/381/111}, you will recall that we got to the point
8 of 2.5%. Then it says:

9 "Estimates of depreciation have been deducted on
10 a straight line basis consistent with the useful
11 economic lives of each asset class and the remaining
12 undepreciated value of the assets."

13 So this is a Postcomm document in relation to PC3
14 which is clearly setting out what the depreciation
15 profile would be; correct?

16 A. Yes.

17 Q. So when you said in your report {E/IC57/56}:

18 "... I have not seen in any Postcomm or LECG
19 document discussion of how assets ... in the RAB were
20 depreciated over the period ..."

21 It was just because you had not looked at this,
22 amongst other documents?

23 A. Well, this does not answer really. It is just the
24 duration of the asset life I do not know.

25 Q. But you know that it is a straight line basis?

1 A. Yes.

2 Q. You know that it is related to the remaining
3 undepreciated value of the particular assets; correct?

4 A. Yes.

5 SIR IAIN MCMILLAN: May I ask a question?

6 MR BEARD: Please.

7 SIR IAIN MCMILLAN: Is the straight line basis being used
8 here, rather than a depreciating asset value basis over
9 time, means that an estimate must have been made of the
10 life of the -- the useful life of the vehicle?

11 Is your point, Mr Harvey, that actually the lifetime
12 of the vehicle was not consistent with the original
13 estimate of its lifetime?

14 A. Well, we do know in fact that there are differences
15 between, I think, the seven or ten-year depreciation
16 profile that Royal Mail used and how long they were
17 actually used for. Here, I was making a slightly
18 different point. It is a small point really, which is
19 about how much of the asset value would have been
20 depreciated within this price control period, and the
21 paragraph that Mr Beard has taken me to does not tell me
22 that.

23 SIR IAIN MCMILLAN: Thank you.

24 MR BEARD: I think it goes back to a point that, Sir Iain,
25 was raised by you previously.

1 Mr Harvey, you know, do you not, that Mr Devine
2 provided evidence that the estimated useful economic
3 life of trucks for Royal Mail was seven years before
4 2010, do we not?

5 A. Yes, I do know that.

6 Q. We do. So actually we do know the answer to that. It
7 is paragraph 5.5 in Mr Devine's statement.

8 SIR IAIN MCMILLAN: Sorry, if I may, just for clarity, we
9 know that the estimated life of the vehicles was
10 seven years, but what was the actual life expect -- of
11 the actual life of the vehicles in practice? Were they
12 different?

13 A. They varied. On average, the number was I think around
14 6, 6.3, 6.5 years, but there was a range around that.
15 The point that is being made here is a little bit
16 different. It is about, even if Royal Mail had its view
17 of the seven-year lifetime, I do not know what
18 Postcomm's view was of those assets. So it may have
19 adopted the seven-year, I do not know.

20 MR BEARD: We have no reason to doubt that. Sorry, the
21 actual life span of trucks is not relevant to the
22 forecast that we are dealing with here. I do not think
23 Mr Harvey is disagreeing with that. He is suggesting
24 there is uncertainty about how it is being assessed in
25 the forecast. I am suggesting that uncertainty is

1 somewhat conected, but that is different from the
2 actual life of trucks.

3 SIR IAIN MCMILLAN: Yes. No, thanks very much. I just
4 wanted to be clear about what point you were both
5 premised on.

6 MR BEARD: Yes.

7 SIR IAIN MCMILLAN: Thank you.

8 MR BEARD: No problem.

9 Let us move on to operating leases for the purposes
10 of forecast operating expenditure. We were looking at
11 capital, now we are looking at opex.

12 The forecast operating expenditure in PC3, so we are
13 still just with Royal Mail, and it is the last component
14 of costs effectively that match up to the allowed
15 revenues. Again, I would hope that we might be able to
16 be relatively brief given the evidence of Mr Jeavons.
17 The evidence of Mr Jeavons was that Royal Mail had
18 initially sought to include leased vehicles in the RAB.
19 Do you recall that?

20 A. Yes.

21 Q. Yes, and that he agreed, and the consultants, LECG, and
22 ultimately Postcomm had not accepted that approach. You
23 recall that too?

24 A. Yes.

25 Q. Yes.

1 So, instead, what we saw was that leasing costs were
2 to be included within operating expenditure; correct?

3 A. Yes.

4 Q. Yes.

5 It is right then, is it not, that LECG then
6 estimated Royal Mail's base year operating costs using
7 actual data from Royal Mail's 2004/2005 accounts?

8 A. That is right, with some adjustments, yes.

9 Q. We will come to that in a second.

10 In the actual 2004 operating expenditure, that would
11 have included operating lease payments for trucks,
12 would it not?

13 A. Yes.

14 Q. Yes.

15 So those base year operating costs were used to
16 project forecast operating costs for the remainder of
17 the price control period; correct?

18 A. Yes.

19 Q. There is no reason to think, is there, that those
20 forecast operating costs would not have included the
21 ongoing costs of operating leases for trucks? I think
22 you accept that?

23 A. Well, it just depends on how the forecasts were
24 compiled.

25 Q. Sorry, you are suggesting that the ongoing operating --

1 the ongoing costs of operating for leases for trucks
2 would not have been included in those forecasts?

3 A. No, I am not saying that. I am saying the level at
4 which those costs would be included depends on how the
5 forecasts were made.

6 Q. Let us just go to the joint statement and see if we can
7 deal with it that way. Can we go to {E/IC83/51}? You
8 say, at the bottom of this paragraph, the main paragraph
9 in the column attributed to you:

10 "I do not consider that trucks financed by operating
11 leases would have been included in the RAB (as Postcomm
12 explicitly excludes these) however certain trucks costs
13 may have been included in the operating costs (though
14 I find whether and to what extent truck costs were
15 included to be highly uncertain)."

16 So we are in your realm of uncertainty again, but
17 you are saying "I do not consider the trucks financed by
18 operating leases would have been included in the RAB";
19 correct?

20 A. Yes.

21 Q. Then, it is not clear what you are referring to by
22 "certain trucks costs". Do you know -- what are you
23 referring to there?

24 A. That would be the operating lease trucks.

25 Q. So this is the operating lease payments for trucks --

- 1 A. Yes.
- 2 Q. -- and they would be included in the base year and
3 forecast operating costs?
- 4 A. Well, they would be included as forecasts. I am saying
5 I do not know what level they would be included at.
- 6 Q. So, are you saying that they would be varied from the
7 base year in a way that somehow meant that those lease
8 payment costs would not have been recoverable by
9 Royal Mail, even though Royal Mail had an interest in
10 putting forward those costs?
- 11 A. No, I am saying it depends on how and what level the
12 lease payments were included in forecasts.
- 13 Q. Let us just test this. It is right, is it not, that the
14 operating lease payments were determined at the start of
15 the lease period based on the purchase costs of the
16 vehicle; correct?
- 17 A. Yes.
- 18 Q. So it follows that, if there was an overcharge on the
19 truck, as you contend, the operating lease payments
20 would have been lower in the counterfactual; correct?
- 21 A. Yes.
- 22 Q. So you would have lower operating expenditure in the
23 counterfactual base year 2004/2005; correct?
- 24 A. Yes.
- 25 Q. It would be lower by the putative overcharge that you

- 1 put forward?
- 2 A. Yes.
- 3 Q. Then the lower projected baseline costs for each year of
4 the price control would then be affected; correct?
- 5 A. Yes.
- 6 Q. So it is highly likely, is it not, that Royal Mail's
7 forecast efficient operating costs would have been lower
8 absent the putative overcharge, is it not?
- 9 A. No, it goes back to how they forecast the costs.
- 10 Q. Well, let us -- how they forecast the costs? So are you
11 saying that this is a matter of Royal Mail or a matter
12 of Postcomm and LECG that modifies this?
- 13 A. In the end, it is Postcomm that matters.
- 14 Q. Well, shall we just look at -- is this to do with the
15 operation of the efficiency challenge by Postcomm that
16 modifies these forecasts?
- 17 A. No, not necessarily. It just depends on how they reach
18 a view as to what the forecast operating lease
19 expenditure would be at any point in time.
- 20 Q. So let us just -- so, we have got no reason to think the
21 efficiency challenge would be different. Surely the
22 forecast costs are based on the actual lease payments,
23 are they not?
- 24 A. I do not know.
- 25 Q. Sorry, you are suggesting, Mr Harvey, that although you

1 are leasing a truck across five years, and therefore you
2 have a pattern of lease payments, you would not put
3 those forward as a forecast?

4 A. Well, it depends what lease trucks they were thinking of
5 taking out during the price control process as well.

6 Q. Sorry, let us just take that in stages. Across the
7 period of price control, where you are making forecasts,
8 you will have trucks -- we know, for example, where they
9 have seven-year expected lives, or depreciation curve
10 useful lives, you will have a pattern of seven years of
11 lease payments, will you not?

12 A. Yes.

13 Q. Now, insofar as you are actually incurring those lease
14 payments, the forecast is pretty easy, is it not,
15 Mr Harvey, because those are real lease payments that
16 you are going to be making across the period of price
17 control; correct?

18 A. Yes.

19 Q. So you are not suggesting that any of those payments are
20 somehow modified, are you?

21 A. No.

22 Q. No.

23 So what you are then saying is that, if you enter
24 into new leases in relation to new trucks during the
25 price control period, you are unsure precisely what the

1 lease payment might be in relation to each of the years
2 included in the price control period for those new
3 trucks; correct?

4 A. Yes.

5 Q. But Royal Mail can make an estimate of that on the basis
6 of the experience it has in relation to the leasing that
7 it is actually undertaking, can it not?

8 A. It could, yes.

9 Q. Yes.

10 But, more particularly, the approach that it would
11 take in relation to that is not going to be materially
12 different depending on whether we are in the real or
13 counterfactual worlds, is it?

14 A. Well, it depends on how it arrives at the view of the
15 lease payment and the extent to which that would be
16 affected by -- sorry.

17 Q. So, let us just be clear. There were no new leases in
18 fact assumed for PC3, were there?

19 A. I do not know.

20 Q. They all seem to be purchased trucks.

21 A. I do not know what was included in the forecasts.

22 THE CHAIRMAN: Are you saying that is from the evidence?

23 MR BEARD: Yes. Yes, we can go back to it that in relation
24 to PC3.

25 As I understand it, you are speculating that any new

1 leases that might have been undertaken in relation to
2 PC3 would have been treated differently by Royal Mail
3 for the purpose of forecasting if there had been
4 a putative overcharge in relation to those leases;
5 correct?

6 A. I am saying that, for example, if I expected to enter
7 into another lease agreement or an existing one, it is
8 revised. I need to take a view on what the truck lease
9 payments would be. It may well be that my view of that,
10 because I am trying to anticipate what they will be in
11 the future, may be independent of an overcharge. It may
12 be simply I think it is going to cost me 7,000, that is
13 my best estimate.

14 Q. I am sorry, I do not understand on what basis you are
15 suggesting that the forecast costs put forward by
16 Royal Mail would have been different in the
17 counterfactual world on this basis other than them being
18 lowered by reference to the absent overcharge. I simply
19 do not understand on what basis you are suggesting
20 a different approach to lease forecasting -- lease
21 payment forecasting should be put forward.

22 A. I am not suggesting a different approach.

23 Q. I see.

24 THE CHAIRMAN: Are you saying you do not know what the
25 approach was?

1 A. I am saying I do not know what the approach was. There
2 is a company trying to consider what it is going to pay
3 in the future for, in this example, lease payments, and
4 it is possible that they need to take a view on how
5 truck costs will evolve over time. That process would
6 be an estimate, and it is possible that that estimate is
7 not conditional on an overcharge, and whilst I just
8 think it is going to be 70,000, you know, for a truck
9 and it would not vary with the overcharge.

10 MR BEARD: But even if they were going to take
11 a different -- on your case, Mr Harvey, you are
12 suggesting that there is a change in the way that they
13 put forward lease payments because of the existence of
14 a putative overcharge, and you have provided no reason
15 why that would be the case.

16 A. I am not saying that there is a difference in approach,
17 sorry.

18 THE CHAIRMAN: I do not think he was saying that.

19 A. I am not saying there is a difference in approach. All
20 I am trying to say is I need to take a view in the
21 factual, so we are in the factual world now, of what the
22 lease payments would be in the future. I might take
23 quite a broad view of that because I know that I cannot
24 change my mind in the future because the price control
25 has been set at wherever it has been set. I may not

1 have changed that view if truck costs in actuality had
2 been lower because I may not have pegged it very closely
3 to the actual truck costs.

4 MR BEARD: But you understand that the estimates of the
5 forecast costs were based on the historic purchase and
6 lease payments, because we have seen the evidence in
7 relation to those?

8 A. Yes.

9 Q. Yes.

10 So there is no reason to think that somehow there
11 would be a variance from that approach?

12 A. It just depends, as I said earlier, on what "based on"
13 means. We do not know.

14 Q. Right. I am not sure I can take that much further.

15 I am going to move on to PC2, if I may. Still with
16 Royal Mail, and I do not really have many questions in
17 relation to that.

18 For the benefit of the tribunal, the shape of PC2
19 was different from PC3 because it was not a regulatory
20 asset based price control. But there was still an RPI
21 minus X glidepath control included in it; that is
22 correct, is it not?

23 A. That is correct.

24 Q. Yes.

25 But allowed revenues were set so as to be broadly

1 cash neutral, taking into account operating capital and
2 renewals expenditure; is that broadly right?

3 A. Yes.

4 Q. Yes.

5 So just on capital expenditure, we can probably be
6 very brief, you suggested in your third report and in
7 the joint statement that it was not clear whether trucks
8 were included in Royal Mail's capital expenditure
9 forecast; do you recall that?

10 A. Yes.

11 Q. Yes.

12 There was one reference to capital expenditure on
13 vehicles and trailers in the relevant documents, the
14 somewhat infamous £75 million that we now know was
15 related to people carriers, not trucks; correct?

16 A. I think I reference that in my report.

17 Q. So that is the only reference to vehicle costs in
18 Royal Mail's forecast capital expenditure, so I think we
19 can agree that the capital expenditure forecast did not
20 include truck costs; correct?

21 A. It seems plausible.

22 Q. So no forecast capital expenditure, and instead, I think
23 Mr Jeavons confirmed that he would expect truck costs,
24 depreciation charges on capital purposes and operating
25 lease payments would have been included in the forecast

1 vehicle services charges; do you recall that?

2 A. Yes.

3 Q. Yes.

4 They form part of forecast operating expenditure;
5 correct?

6 A. Yes.

7 Q. Yes.

8 Now, did you look at the Atkins report in relation
9 to these matters at all?

10 A. Yes, I have.

11 Q. So, do you recall, as confirmed by Mr Jeavons, that
12 Atkins accepted those vehicle costs as part of the
13 forecast operating expenditure?

14 A. Yes, I do recall that.

15 Q. Right. So we can agree that it is a question of fact
16 whether the forecast operating expenditure would have
17 included truck costs; correct?

18 A. Yes.

19 Q. We have evidence from Mr Jeavons and we know that you
20 did not ask further questions in relation to it.

21 So just moving to the counterfactual, the actual
22 forecast operating expenditure was based on Royal Mail
23 fleet's internal charges; you know that?

24 A. Yes.

25 Q. Yes.

1 So if Royal Mail fleet's internal charges were lower
2 in the counterfactual, then the forecast operating
3 expenditure would have been lower in the counterfactual
4 as well; correct?

5 A. Yes.

6 Q. Then, let us just move on to calculating X. You accept,
7 I think, that forecast operating expenditure was an
8 input into Postcomm's modelling used to generate X;
9 correct?

10 A. Yes.

11 Q. Yes.

12 I know you will say, well, we do not have all the
13 financial modelling details, but we can agree, can we
14 not, that the forecast operating expenditure was an
15 input into the model, and that if that number went down,
16 then all else being equal, you would expect the model to
17 produce a lower value for X; correct?

18 A. Yes.

19 Q. Yes.

20 So, in those circumstances, even though we cannot
21 see the Postcomm model, it is reasonable to assume, is
22 it not, that if expected costs went down, then allowed
23 revenues would go down too, all else being equal;
24 correct?

25 A. So what you have taken me through is, numbers go into

1 a model, the output of a model changes. The step that
2 is very important, however, is whether the X then that
3 is implemented in the licence changes, and I do not know
4 whether we are going to talk about that.

5 Q. I am testing it on the basis of all other things being
6 equal. I understand your position is you do not treat
7 all things as being equal and that things may well
8 change in the modelling; that is correct, is it not?

9 A. No, that is not right. So, the point is that the 3%,
10 which is the initial increase in prices, in price
11 control -- that was allowed in price control 2 and the X
12 factor that was applied, which was 1%, so the glidepath
13 was RPI minus 1 for everything but the first year, those
14 figures were arrived at not exclusively on the basis of
15 this sort of cost modelling that we have just spoken
16 about. They arrived, firstly, on the 3% increase.
17 Royal Mail had a restructuring programme that they
18 wanted to implement which they thought would cost
19 something to the tune of £170 million a year, they
20 wanted this restructuring programme I think for some
21 time, and the 3% increase was to allow that.

22 The efficiency factor was changed through this
23 process so, originally, they, Postcomm, were thinking
24 about this price control as sort of a roll over from the
25 first price control, and what they originally had in

1 mind was an RPI minus 2.5% price control. At the time,
2 the inflation target for the Bank of England was 2.5%,
3 and so sort of what they were sort of trying to get to
4 here was a sort of no nominal change in prices, and part
5 of the motivation for this idea of a rollover was that
6 they had not really got in place all the mechanics they
7 needed to calculate the price control. Specifically,
8 they were concerned about the cost information that
9 Royal Mail had access to. So that was why they started.

10 Then, shortly before price control was implemented,
11 in view of additional information from Royal Mail, they
12 changed the efficiency factor from 2.5 to 1. This was
13 a few months before the price control was implemented.

14 The reason I have raised all of that is that I do
15 not think it is right to look at this price control as
16 a "Let us go and calculate the costs, add them all up
17 and generate an X factor", which is why, in response to
18 Mr Beard's question, I have made the distinction between
19 any such number that pops out of a modelling process on
20 the one hand, and the considerations that went to
21 actually setting the price path on the other, which are
22 far broader.

23 Q. I understand, the point you are making is that there are
24 a series of other decisions that are made by Postcomm in
25 the light of the particular situation pertaining to what

1 you refer to as the 170 million in respect of
2 Royal Mail, but all of those decisions are being made,
3 again, in circumstances where, in the real world, as you
4 would have it, there was a heightened level of cost; in
5 the counterfactual world, there would have been a lower
6 level of cost. You are not suggesting that any of those
7 decisions on these large sums to which you are referring
8 would have been made differently in the counterfactual
9 world, are you?

10 A. No, I am not. But that is not the same as saying the X
11 factor would have moved down by a micron of a percentage
12 point. What I am saying is that the way in which the 3%
13 and the 1% was arrived at pegs the prices to RPI
14 minus 1, even if you did a calculation which showed
15 that, if the costs were lower, you would have preferred
16 to have set RPI minus 0.975, or something like that.

17 So it is not a question, Mr Beard, of things
18 changing. I am actually saying that those things are
19 things that matter, the 3% and the 1% would have stayed
20 the same.

21 Q. I understand, but my question was in relation to the
22 decisions that were made in relation to those major
23 issues, and you have answered in relation to that. No
24 doubt Mr Bezant will be asked questions about the
25 approach to modification of PC2.

1 A. Yes.

2 Q. Now, I just want to pick up very briefly on the prior
3 periods, so government period and PC1. This is going
4 back in time, before the regulatory regimes that we have
5 been discussing, so 1997 to 2003. I think that you and
6 Mr Bezant agree that these periods together account only
7 for about 20% of the putative overcharge, I think that
8 is right?

9 A. That is about right, yes.

10 Q. Yes.

11 I think you also agree that there is essentially an
12 intrinsic link between the government period and PC1, as
13 it is called, and for the benefit of the tribunal, that
14 is because although Postcomm was involved in the PC1
15 period, it has essentially maintained the status quo of
16 the government period; is that fair?

17 A. Yes, there is a link, yes. They basically froze the
18 prices of some products and allowed the prices of others
19 to change with RPI.

20 Q. Yes.

21 Now, I am not going to go back into the question
22 about your enquiries and investigations in relation to
23 these matters, but one piece of information that is
24 available and was discussed with Mr Barnes is the price
25 of stamps from 1993 onwards.

1 Now, it has been suggested at various points in this
2 case that, in order to show supply pass-on, DAF would
3 need to show some kind of overcharge caused an increase
4 in the price of stamps. But I think you would accept,
5 would you not, that Royal Mail had many other products,
6 even during the government period, where small changes
7 in pricing could generate revenues around the size of
8 the overcharge you allege; correct?

9 A. There were, obviously, lots and lots of products, so
10 yes. Stamps accounted I think for quite a high
11 proportion of sales at that time, the first and second
12 class product. So I think -- I do not -- I cannot find
13 the figures now, but I think it is in the region of 25%,
14 something like that. It is a high proportion.

15 So I think the -- it is relevant to look at what
16 happened to the prices of stamps to understand the
17 extent to which they are cost reflective.

18 Q. Well, you say it is instructive to look at the price of
19 stamps, but we know that stamps have a number of
20 characteristics, not least their public profile, that
21 means that there is a certain stickiness in relation to
22 the changes in pricing at this time; correct?

23 A. Yes.

24 Q. Whereas in relation to other services, including
25 business services, one would not necessarily expect the

- 1 same sort of stickiness; correct?
- 2 A. I do not know but ...
- 3 Q. Mr Bezant has identified things like international
4 priority services and special delivery services as
5 potential candidates where prices could be flexed
6 without there being that sense of stickiness or, rather,
7 that these changes could occur and there is no
8 indication that there would be stickiness in relation to
9 those products. You do not disagree with Mr Bezant in
10 relation to that, do you?
- 11 A. Sorry, which part of it?
- 12 Q. He has identified a range of products where there could
13 have been small increases in price which would have
14 resulted in revenues that would have been effectively
15 around the size of the alleged overcharge.
- 16 A. I am sure there are.
- 17 Q. Yes. Mr Bezant's position is that there is likely to
18 have been a link between Royal Mail's costs and its
19 prices based on the information which does exist, and
20 I do not think you actually disagree with that, do you?
- 21 A. Sorry, at the very general level, prices reflecting
22 costs, I do not disagree with that, no.
- 23 Q. Assuming for a moment that there was a link between the
24 price -- Royal Mail's costs and its prices, in
25 circumstances where it incurred lower costs in the

1 counterfactual scenario, that would be an indication
2 that Royal Mail would have likely set lower prices in
3 relation to products, perhaps other than stamps;
4 correct?

5 A. No, I do not think you can draw that conclusion.

6 Q. It would not even be an indication?

7 A. I think what it would tell you is that a company is
8 generally setting its prices to reflect its costs. It
9 does not tell you about how a company would respond to
10 a small change in prices.

11 Q. I see. Well, I think we disagree about that, Mr Harvey,
12 but I will move on.

13 I am actually going to jump forward now, since we
14 have gone all the way back to the beginning of the
15 government period, just to the Ofcom period, so this is
16 the period after PC2 and PC3. This is from 2012 when
17 Ofcom introduced a new regime, largely involving the
18 deregulation of Royal Mail. You understand that?

19 A. I do, yes.

20 Q. There were no specific price controls during this
21 period; correct?

22 A. There was a cap on second class stamps.

23 Q. Yes.

24 A. But otherwise no. Well, sorry, there was a cap on
25 second class stamps and there was a margin squeeze

1 regulation but not of the type that -- where we have
2 discussed in relation to price control 3 --

3 Q. There was the margin squeeze control that is quite
4 right. This accounts for around 6% or 7% of the putative
5 overcharge on your account?

6 A. Yes.

7 Q. Yes, and I think it is common ground between you and
8 Mr Bezant that Royal Mail had regard to factors other
9 than costs when it set its prices; correct?

10 A. Yes.

11 Q. But Mr Bezant's position in relation to the Ofcom period
12 is that there is actually a strong relationship between
13 Royal Mail's costs and its prices; you understand that?

14 A. Yes.

15 Q. His position is -- on which he will no doubt be
16 cross-examined -- that that means that it is more likely
17 that Royal Mail would therefore have offered lower
18 prices in a counterfactual scenario than when it had, on
19 your case, lower costs; correct?

20 A. I understand that, yes.

21 Q. You disagree with him in relation to that?

22 A. I do.

23 Q. Just briefly on non-regulated or non-price-controlled
24 products, it is right, is it not, that you have not
25 yourself estimated the proportion of putative

1 overcharge-related costs which were allocated to
2 Royal Mail's non-regulated or regulated but
3 non-price-controlled products during in particular the
4 Postcomm period; correct?

5 A. That is correct.

6 Q. Yes, and you are aware that Mr Bezant has assessed it at
7 around 10%; correct?

8 A. Yes.

9 Q. You do not actually have any reason specifically to
10 disagree with that estimate; correct?

11 A. No.

12 Q. In relation to the regulated but not price-controlled
13 products, which is around 3% I think, Mr Bezant has
14 treated them in the same way as the price-controlled
15 products; you understand that?

16 A. Yes.

17 Q. And that given what a small proportion of Royal Mail's
18 products this represents, that is a reasonable and
19 proportionate approach in the circumstances, is it not?

20 A. No, I am not sure it is because there are some
21 differences between those products and the regulated
22 products.

23 Q. Well, is the central difference that they were not in
24 a price control so Royal Mail could have priced how it
25 liked?

- 1 A. That is one of them, yes.
- 2 Q. Is that a key difference?
- 3 A. That is a key difference. There are other differences
4 that I have set out in my report but I would need to
5 flick to it to look at this 10% of 30%.
- 6 Q. So you think it should be dealt with separately, this
7 3%, and it is not reasonable and proportionate to deal
8 with it in the same way?
- 9 A. I think the question is whether for those products it is
10 right to take the inference from the way price control
11 worked for products that are not.
- 12 Q. Now, in relation to non-regulated products, you agree
13 that there is not a great deal of information available
14 to enable an assessment of supply pass-on, I think that
15 is common ground; correct?
- 16 A. Yes, I think that is right.
- 17 Q. So in relation to that category of products, you
18 understand that Mr Bezant's position is that there was
19 a link between Royal Mail's costs and its prices for
20 those non-regulated products, based on his review of
21 Royal Mail's price-setting processes. I do not think
22 you actually disagree with that proposition, do you?
- 23 A. No.
- 24 Q. No. I think the position therefore is that, on DAF's
25 case and Mr Bezant's position, it is likely that prices

1 would have been lower in the counterfactual for these
2 non-regulated products had, on your case, Royal Mail
3 faced lower costs; but you disagree with that, correct?

4 A. Yes.

5 Q. Assuming for the purpose of this question that Mr Bezant
6 is right about there being a link between cost and
7 prices for non-regulated products, it is right, is it
8 not, that in the counterfactual Royal Mail would likely
9 have set lower prices?

10 A. No, that does not follow.

11 Q. Now, finally in relation to Royal Mail matters, I just
12 want to put a couple of questions on Parcelforce. For
13 a number of the other areas we have discussed, you and
14 Mr Bezant are in broad agreement about how one allocates
15 the relevant percentage of any putative overcharge. For
16 Parcelforce there is a difference between you; that is
17 correct, is it not?

18 A. That is right.

19 Q. I think you suggest that around 10% of the putative
20 overcharge should be allocated to Parcelforce whereas
21 Mr Bezant allocates around 5%; correct?

22 A. That is right.

23 Q. I think you understand the difference arises because
24 Mr Bezant allocates truck cost based on relative
25 revenues generated by Royal Mail and Parcelforce;

- 1 correct?
- 2 A. Yes, that is right.
- 3 Q. I suggest to you that is a perfectly reasonable
4 approach, allocating by reference to relative revenues.
5 Do you say that is an unreasonable approach?
- 6 A. We do both need to arrive at an estimate. There is some
7 evidence and my calculation suggests that Parcelforce in
8 a sense punched above its weight in terms of its usage
9 of trucks, and so my evidence suggests that it would be
10 higher than its share of revenue.
- 11 Q. Sorry, I understand that you have a different approach,
12 but are you saying that Mr Bezant's approach is
13 unreasonable?
- 14 A. Yes, I think I am because it depends -- I have found
15 evidence to suggest that a higher number is justified.
- 16 Q. You have found evidence, you have been through the
17 documents?
- 18 A. Yes.
- 19 Q. Right. So there are three categories, broadly speaking,
20 of Parcelforce customers; there are consumers who pay
21 tariff rates, business customers and international
22 customers; correct?
- 23 A. Yes.
- 24 Q. The business customers actually account for the majority
25 of Parcelforce revenues; correct?

- 1 A. Yes.
- 2 Q. Most of the business customers negotiate bespoke rates;
3 correct?
- 4 A. Yes.
- 5 Q. We know, do we not, that Parcelforce had bespoke pricing
6 models; correct?
- 7 A. Yes.
- 8 Q. Now, have you read the transcript of Mr Cahill's
9 evidence?
- 10 A. Yes.
- 11 Q. So you are aware of the evidence that Mr Cahill gave
12 that the pricing model was updated regularly and for
13 relatively small changes in cost?
- 14 A. Yes.
- 15 Q. You are also aware of the evidence from Mr Cahill that,
16 at least in relation to the 2007 pricing model that was
17 exhibited to his witness statement, at least in relation
18 to that model, a price was generated based on the costs
19 plus an inputted margin?
- 20 A. Yes. Sorry, is this the same model that I have referred
21 to in my report, the "amend this one to get this one"
22 I think?
- 23 Q. Yes, that is right.
- 24 Mr Bezant's assessment, taking into account all the
25 evidence in the round, is that there was a strong

1 relationship between Parcelforce's costs, including
2 truck costs, and its prices. That is fair in terms of
3 his assessment, correct?

4 A. Yes.

5 Q. It would follow from that, would it not, that it is
6 likely that prices would have been lower in the
7 counterfactual scenario if Royal Mail had, on your case,
8 lower costs; correct?

9 A. No.

10 Q. Again, I think the point you are making is that,
11 although costs may influence prices, you assume that the
12 level of change in the counterfactual is not such as to
13 change the prices in question?

14 A. Yes.

15 Q. It is because the changes are not sufficiently granular;
16 correct?

17 A. Broadly, yes, and there are other factors that led to
18 those prices that were not cost related.

19 Q. Now, I am going to move on from Royal Mail to BT if
20 I may but, obviously, if the tribunal has any particular
21 questions in relation to Royal Mail matters, I do not
22 know whether now is a good moment.

23 So if we move on to BT, I want to focus on Openreach
24 because it is key for BT supply pass-on analysis.

25 I think everyone agrees on that.

1 A. Yes, I agree.

2 Q. Just so that we have all got in mind the structure of BT
3 for these purposes, I am going to go to figure 2.1 of
4 Mr Bezant's report which is {E/IC26/24}. The tribunal
5 will recall I showed this to Mr Nicholson who was
6 a witness for BT.

7 Here we have a diagram prepared by Mr Bezant: the
8 recharge and supply pass-on of the cost of trucks,
9 proportion of total costs included in BT's claims. Now,
10 leave aside for the moment that you and Mr Bezant
11 disagree about the outturn of supply pass-on, I think
12 for the most part the numbers actually included here
13 about the proportion of total costs, there is not
14 a disagreement in relation to. Is that broadly right?

15 A. That is broadly right and I think there is some
16 refinements that took place, through the process of
17 exchanging reports, to the figures but, broadly
18 speaking --

19 Q. Broadly speaking, yes.

20 So we have got DAF on the left-hand side providing
21 trucks to BT Plc's vehicle operations, BT Fleet. Then
22 around 60% of the truck costs would be allocated to
23 Openreach. I think on that there is broad agreement;
24 correct?

25 A. Yes. Let me -- can I just -- you are going to ask me if

1 I agree with all these figures so let me open up the ...

2 Q. Sure. I think broadly we do. I do not actually have
3 a reference here but I think broadly there is agreement
4 in relation to this.

5 A. I am happy with the order of magnitude of the figures.
6 My reports contain revised estimates so it depends how
7 material this is and what happens next.

8 Q. Sorry, let us just clarify this because orders of
9 magnitude are a dangerous measure --

10 A. They are, yes.

11 Q. So if we could go to {E/IC71/36}. This is Mr Bezant's
12 third report and I think the reason I was not taking
13 issue with "broadly" is because, in relation to this, if
14 one looks at the tables, on "Recharge and resale", you
15 see at the top Mr Bezant on the far right-hand side,
16 60.2%, and you say 62.1%.

17 A. Yes.

18 Q. So not a technical order of magnitude of difference.

19 A. No.

20 Q. Then "BT Supply Chain", again less than 2% difference.
21 I think the largest difference is actually in relation
22 to "Residual value".

23 A. Yes.

24 Q. So let us just go back to the diagram we were on, so
25 {E/IC26/24}, please. Here we see 60%, or you say 62%,

1 going through to Openreach. Then we have "BT Supply
2 Chain" just above it which is 26% on the diagram, but
3 I just took you to --

4 A. Yes.

5 Q. -- the difference between you, but it is small.

6 Then "Other LOBs" at the top where, again, I think
7 there was a very limited difference between the two.
8 Then I think at the bottom, that is where you have the
9 residual -- is that correct? -- 10% at the bottom, you
10 say it is 5%.

11 A. That is right, yes.

12 Q. We then have from Openreach, Openreach recharging
13 various other elements of the BT business, as does BT
14 supply chain and then that feeding through to external
15 customers who are in green there, yes?

16 A. Yes.

17 Q. Just to assist -- and I think this is common ground --
18 it is right, is it not, that the vast majority of
19 Openreach products were regulated during the relevant
20 period; correct?

21 A. Yes.

22 Q. It is also right, is it not, that BT purchased all of
23 its trucks so we do not have any leased trucks issues
24 with BT, yes?

25 A. Yes.

1 Q. So it follows that all BT trucks were accounted for as
2 capital costs and so they would appear on the balance
3 sheet in the regulatory financial statements as assets;
4 correct?

5 A. Yes.

6 Q. I am going to start at the back end of the discussion in
7 relation to Openreach because I think it might help just
8 to set out why I am asking you some of these questions.

9 We know that in relation to Openreach and the scheme
10 of regulation, there were a large number of glidepath
11 controls which applied to it during the relevant period;
12 correct?

13 A. I think around half to 60% of the regulation was
14 glidepath control and the other half/40% was
15 a combination of fixed price caps and cost orientation
16 measures.

17 Q. So fixed price caps, you say, but is this charge
18 ceilings that you are referring to?

19 A. Yes.

20 Q. They work just slightly differently from a fixed price
21 cap, do they not? But for the purposes of the analysis,
22 it does not make a material difference to the
23 probability analysis we are going to --

24 A. No, it does not.

25 Q. But let us just go back a step.

- 1 A. The cost orientation measures are different.
- 2 Q. Cost orientation measures are different. But let us
3 just stick with the glidepath charge controls. You have
4 talked about there being a chunk of the regulated
5 activity being subject to glidepath controls, there
6 being another chunk subject to charge ceilings, fixed
7 price caps and then cost orientation. But the question
8 I asked you was about the numbers of glidepath controls
9 and I think you accept that there were a large number of
10 glidepath controls applicable to Openreach during the
11 relevant period; correct?
- 12 A. In my original report, we identified 30 or so. In the
13 joint statement process, Mr Bezant identified an
14 additional 40 or so and, as I suspect we will go on to
15 talk about, some of those 40 additional glidepaths are
16 actually other years within the existing glide paths
17 that I looked at. Some of them are different and some
18 of them -- most of them relate to the period '15/'16
19 onwards, for which a relatively small proportion of the
20 overcharge is left to be depreciated.
- 21 Q. We will come back to proportionality in a bit. I think
22 you are accepting -- you identified 40, there were
23 another 40. I think you are suggesting that some were
24 effectively overlaps with the 40 that you had
25 identified; correct?

- 1 A. Yes, they should be treated as sort of independent.
- 2 Q. But some were different that have been identified?
- 3 A. Yes.
- 4 Q. So you are talking about more than 40 but less than 80?
- 5 A. Yes.
- 6 Q. Now, I think it is common ground between you and
7 Mr Bezant, is it not, that the way to assess the
8 likelihood that any putative overcharge was passed on by
9 Openreach is to analyse the probability that at least
10 one of the charge controls would have been different in
11 the counterfactual? I think that is agreed between you;
12 correct?
- 13 A. Well, I am interested in the likelihood of each --
14 whether each glidepath would round or not. One can also
15 calculate the likelihood that at least one of them would
16 round.
- 17 Q. But if you are looking at the likelihood of each
18 changing, I am going to come on to rounding, but each
19 changing, you can also analyse the collection of those
20 probabilities to consider whether or not it is likely or
21 more likely than not that one of them would change;
22 correct?
- 23 A. You can analyse that, yes.
- 24 Q. When we are talking about glidepath controls changing,
25 what we are talking about is the probability of the X in

1 the glidepath being different in the counterfactual;
2 correct?

3 A. That is correct.

4 Q. Now, let us just go to your first report where you
5 explain the rationale for the probability analysis. So
6 {E/IC7/28}, if we could just go back a page if we may,
7 sorry, I think it may be 27 or even earlier, 26. I want
8 1.79, that is the paragraph I am looking for, apologies.
9 {E/IC7/26}.

10 Now, this is where we get into this concept of
11 rounding:

12 "If key parameters of regulation are rounded to some
13 degree when determining prices, this can limit the
14 likelihood that a change in one cost category will lead
15 to a corresponding change in the starting price or
16 glidepath figures. In a precise, unrounded calculation,
17 a change in costs could lead to a proportionate change
18 in the price cap or glidepath. By contrast, if values
19 are rounded, then a change in costs would only affect
20 the price cap if the change was sufficiently large (ie
21 larger than the scale of the rounding), or if the
22 unrounded value is very close to the rounding boundary
23 so that a smaller change is enough to move it over the
24 boundary."

25 So this is where your issue of rounding arises. If

1 you are dealing with a particular control where the
2 control is operated on the basis of a cost stack, for
3 example, and one of the components of the cost stack
4 changes, if it is an unrounded control, then it
5 automatically changes with the change in the cost stack.
6 If it is a rounded control, then it depends how large
7 that cost change is as to whether or not it causes the
8 control to move up or down; correct?

9 A. That is correct.

10 Q. But the other situation is that, even if the change in
11 the cost is not large, if the current position of the
12 cost stack is close to the rounding boundary, that small
13 change in cost could tip it over into a different
14 rounding category; correct? Those are the two issues --

15 A. Those are the two considerations, yes.

16 Q. Then at 1.80 you say:

17 "It is not possible to say with certainty whether
18 rounding would have led to a different level of
19 regulation without knowing the original unrounded
20 figure. As the unrounded figure is not quoted in the
21 market review statements, I cannot say where rounding
22 would have led to a different figure in the
23 counterfactual. However, it is possible to estimate the
24 likelihood that the overcharge would have led to
25 a different rounding based on the size of the

1 overcharge. The intuition is as follows:

2 "If the overcharge were zero, then there would be
3 a zero probability that the rounding would be different.

4 "If the overcharge was larger than the level to
5 which the figure was rounded (eg one decimal point), it
6 would necessarily lead to different rounding.

7 "In between these extremes, the probability would
8 increase from zero to one in a uniform fashion."

9 Here you are just explaining the maths of how you do
10 the probability analysis, correct?

11 A. That is right, yes.

12 Q. Now, you have some discussion in 1.81 and 1.82 of your
13 results and you find that there is a low probability of
14 the overcharge affecting the rounding in any one
15 particular case, but at that stage you did not consider
16 the probability of at least changing one of the
17 glidepaths. There was no aggregate analysis at this
18 stage in your report; is that right?

19 A. I think I did consider that possibility.

20 Q. It may be in your second report.

21 A. It may have been my second report.

22 Q. I was just going to come to your second report. So it
23 was at this stage --

24 A. At this stage.

25 Q. So I am going to come on to your second report. Let us

1 just go to that. It is {E/IC30/18}. This is you
2 picking up some comments of Mr Bezant which I am not
3 going to go back through. Sorry, do you have it?

4 A. Sorry, Mr Beard, I am awash with folders.

5 Q. I do not think we have provided you with a hard copy of
6 it. Do you have a copy of your second report? It is
7 probably around page 18, 2.35 which is the paragraph
8 I was going to go to.

9 A. Yes, it is tab 7.

10 Q. Great. Do you have 2.35?

11 A. Yes.

12 Q. "Mr Bezant is correct in outlining the implications of
13 rounding as a matter of principle."

14 Mr Bezant will no doubt comment on these things in
15 due course.

16 "However, he has not engaged with the likelihood
17 that the overcharge would have led to different
18 (rounded) X figures. That is, Mr Bezant has not
19 considered directly whether (i) or (ii) would be more
20 likely for each regulatory period ..."

21 So I guess we had better just go back up to 2.34 to
22 see what (i) and (ii) are. So this is Mr Bezant, 2.33,
23 setting out his assessment. Then at 2.34:

24 "In reaching this position, Mr Bezant notes that the
25 effect of any rounding on X would be either (i)

1 proportionately greater than the overcharge, if the
2 overcharge led to rounding to a different figure, or
3 (ii) proportionately smaller than the overcharge, if the
4 overcharge did not lead to rounding to a different
5 figure."

6 So that is a sort of amplificatory effect of
7 rounding potentially in (i) or a reduced effect in (ii).

8 A. Yes.

9 Q. You then say:

10 "... Mr Bezant has not considered directly whether
11 (i) or (ii) would be more likely for each regulatory
12 period, notwithstanding that such analysis was possible
13 based on the available evidence. As outlined in my
14 First SPO Report, the evidence shows that the
15 probability that the overcharge would have led to
16 a different rounded figure of X was lower than 7% in all
17 cases tested, and lower than 5% in all cases after 2008,
18 sometimes substantially [lower]. Furthermore, I have
19 since estimated that the probability that none of these
20 would have rounded to a different figure is greater than
21 60%. In other words, based on the available evidence,
22 it is more likely than not that the overcharge would not
23 have led to a different rounding in any of the glidepath
24 (X) figures."

25 So what you have done here is an aggregate analysis.

1 A. Yes.

2 Q. What you have said is, "When I analyse all of these
3 glidepath rounding changes, I come up with an estimate
4 that it is 60% -- that the likelihood is greater than
5 60% that there is no different figure"; correct?

6 A. That is correct.

7 Q. So what you are saying at this stage is there is a 40%
8 probability that at least one of the X figures would
9 have changed in the counterfactual; correct?

10 A. That is right.

11 THE CHAIRMAN: Is that a convenient moment?

12 MR BEARD: Yes, I was just thinking actually that probably
13 is a convenient moment because there is some more
14 legwork to do with this. Thank you.

15 THE CHAIRMAN: 2 o'clock then.

16 (1.03 pm)

17 (The short adjournment)

18 (2.00 pm)

19 THE CHAIRMAN: Yes, Mr Beard.

20 MR BEARD: Thank you, sir.

21 So, before the short adjournment, we were looking at
22 your aggregate probability analysis for the glidepaths
23 that you had considered in your second report, which
24 I think was around 29 glidepaths at that point. You
25 said 60% more likely that none of them would change on

1 the basis of the analysis you put forward. But I just
2 want to look at two issues.

3 In that analysis, you did not take any account of
4 recharges from BT supply chain to Openreach; that is
5 correct, is it not?

6 A. That is right.

7 Q. It is also right that you worked on the basis that truck
8 costs were not capital costs on which BT would have
9 earned a return on capital; correct?

10 A. Correct.

11 Q. Yes.

12 Now, I think you have actually analysed in your
13 third report what happens to your probability analysis
14 if you do include those matters, so I think it is at
15 {E/IC58/22}. I am not going to go through this in great
16 detail, but you have got a table there of adjusted
17 average probabilities, including return on capital
18 employed, the ROCE, as one of the variants. I just
19 actually want to move across to the next page
20 {E/IC58/23}, 3.30. Here, you say that when you use --
21 you say:

22 "With a probability of the overcharge changing the
23 rounded value of X in any individual price control of
24 2.8%, there would be a 40% chance that none of the
25 glidepaths change, meaning that there is a greater

1 chance that ... one [of them] does ..."

2 Now, that 2.8% probability, that is the probability
3 you calculate if you include the BT supply chain
4 recharges; that is correct, is it not?

5 A. That is correct, yes.

6 Q. Then, you have also calculated it separately I think for
7 the situation if you include both the BT supply chain
8 recharges and the ROCE for BT, and that is at 3.31; that
9 is correct, is it not?

10 A. That is correct, yes.

11 Q. There, although you do not set it out, I think the maths
12 is that precisely that the probability of at least one
13 of those 29 glidepaths changing is 68%?

14 A. Yes, the total of 37 and 31.

15 Q. Yes, exactly. We are in the same place on the
16 arithmetic.

17 So I just want to look at those two issues. I will
18 start with the second of them: Openreach, was there
19 a ROCE applied to capital costs of trucks. Now, you
20 have already accepted that BT would have treated trucks
21 as capital assets, but you say it is uncertain whether
22 a ROCE would have been applied to the truck costs; in
23 other words it is uncertain whether BT would have been
24 allowed by the regulator to earn a profit element on its
25 truck costs; correct?

1 A. Yes.

2 Q. Yes.

3 Now, you say in particular that there is a lack of
4 clarity about the accounting treatment of CHCs, which
5 are contract hire charges; correct?

6 A. Yes.

7 Q. Yes.

8 Now, the CHCs, these contract hire charges, they are
9 internal charges levied by BT Fleet to the other BT
10 lines of business that used trucks; correct?

11 A. Correct.

12 Q. Yes.

13 So let us just go to where you deal with this in
14 your third report, so {E/IC58/19}. Can we just go down
15 to 3.23, please? You say:

16 "In addition, as stated in my Second SPO Report, it
17 is not clear that the ROCE applies (in full) to truck
18 costs. This is because in the cost data I have
19 reviewed, motor transport costs have been split between
20 operating costs and capital costs -- whereas the ROCE
21 only applies to the latter -- and it is not clear
22 whether CHCs (which would contain any overcharge
23 included in depreciation of truck costs) were recorded
24 under operational or capital motor transport costs."

25 So that is the essence of your concern about ROCE;

1 correct?

2 A. Yes.

3 THE CHAIRMAN: Sorry, CHCs is?

4 MR BEARD: Contract hire charges, sir.

5 THE CHAIRMAN: Contract hire charges. Okay.

6 MR BEARD: Sorry. We can go back to the original diagram,

7 but if you remember, what happens is DAF provides --

8 sells trucks to BT, they are purchased outright, but

9 they are purchased by BT Fleet. BT Fleet then

10 essentially provides them to other BT entities and there

11 is a contract hire charge, which is an internal --

12 THE CHAIRMAN: Yes, thanks.

13 MR BEARD: Sorry, okay.

14 I think you accept it is a factual matter how truck

15 costs were treated for accounting purposes, and I think

16 it is pretty clear from your previous answers, you have

17 not asked anyone at BT about these issues, but we did

18 ask Mr Nicholson about it. Have you seen the transcript

19 of Mr Nicholson's evidence?

20 A. I have, but show me the paragraph.

21 Q. Now, he confirmed, by reference to the detailed

22 attribution methods document, that the regulatory

23 financial statements apportion actual cost, not the

24 internal cost, and it is the actual costs of trucks to

25 BT that is a capital cost; is it not?

1 A. My interpretation of that statement is that the
2 regulator is concerned about not including a --
3 accounting a margin, an internal margin from one
4 internal company to another. So it is worried about
5 that.

6 For CHC costs, CHC charges, they were cost
7 reflective, they were based on the actual truck cost.

8 Q. Let us just go to Mr Nicholson's evidence, shall we?
9 Then we will go to a couple of documents perhaps. So
10 could we go to transcript {Day3/85}, please? You will
11 see, at line 4 {Day3/85:4}, I am asking questions. I am
12 "Q" and Mr Nicholson is "A" in this context. "Could we
13 go --" it says -- and we will come back to this
14 document:

15 "Could we go to {I6/221/102}? I am not even going
16 to begin to try and contextualise what I am asking you
17 about in the overall scheme of the regulatory mechanism,
18 but here we have a sector about motor transport. This
19 is obviously concerned with the cost values and
20 calculations in relation to motor vehicles."

21 So let us just pause there. We will just call it up
22 so that we have got it in mind and then we will come
23 back to this transcript. So could we have {I6/221/102},
24 please? The tribunal may remember this, this is in the
25 definitional section of the relevant document dealing

1 with motor transport. If we just go down, it has new
2 vehicles, leased vehicles, and so on. If we could just
3 go to page 1 so we can see what this document is
4 {I6/221/1}, so this is the "Detailed Attribution
5 Methods ...", the DAM document. You are familiar with
6 it?

7 A. Yes.

8 Q. Yes.

9 So if we could go back to the transcript, please.
10 The reference is Day 3, page 85, {Day3/85}. Fabulous,
11 thank you:

12 "So you will see at the top there it says:

13 "'This sector contains the asset values and
14 depreciation of motor vehicles used in BT's business'.

15 "So this is the whole of BT's business --"

16 You understand that?

17 A. Yes.

18 Q. Yes.

19 "-- as we have discussed.

20 "'BT operates ..."

21 This is a quote again:

22 "'... a range of vehicles purchased as new vehicles
23 or acquired under lease arrangements. Vehicle assets
24 are recorded under two main Classes of Work ...'"

25 So these are -- I am just then dealing with a couple

1 of acronyms.

2 If we could just go over the page then, a little
3 further down. Yes:

4 "... the first class of work ... That includes --
5 the reason why this one is relevant is because it
6 includes not only pool cars, vans ... but [it also
7 includes] heavy goods vehicles ... I think you recognise
8 that the trucks we are talking about in this case would
9 fall within that category."

10 Mr Nicholson says yes.

11 "I will skip over the next class of work ... then go
12 down to page 176 ..."

13 So let us go to that, so {I6/221/176} if we could,
14 please. If we just go down the page, I am just showing
15 this to the tribunal and to Mr Harvey so that they have
16 it in context for the transcript, this is the motor
17 transport fixed assets.

18 Okay. If we could just then go back to the
19 transcript, I think we were on page 86 now {Day3/86}.

20 Yes.

21 "We are now in the base methodology dictionary so it
22 does more than a mere glossary, this document ...
23 halfway ... 'Motor Transport Fixed Assets'."

24 Then I go to the description:

25 "... Net Book Value ... of Motor Transport fixed

1 assets."

2 Then you will see I quote:

3 "It says the methodology is:

4 "'[The] Group unit makes detailed internal transfer
5 charges with regard to which units use its service, an
6 ASPIRE report can be produced of the internal transfer
7 charges identifying the Products and Plant Groups ...
8 which are served by it ...'."

9 Then I ask {Day3/87}:

10 "Now, all I want to just clarify here is whether you
11 understand the reference to 'internal transfer charges'
12 to be a reference to the internal charges from BT Fleet,
13 that we saw in [the] initial diagram, to other business
14 within BT; is that correct?

15 "That is correct, yes."

16 So he was there recognising the internal transfer
17 charges there being specifically covered.

18 Then I went down to a further section in this
19 document, so if we could just look at that, which is
20 {I6/221/1006}. These are the various sector
21 allocations. I have lost where it is. I think if you
22 scroll down. Yes, it is down, second from the bottom.
23 There we have it:

24 "Motor Transport costs apportioned using an analysis
25 of the activity of units receiving the transfer charge

1 from BT Fleet Management."

2 If we could then go back to the transcript,
3 {Day3/87}, thank you. Actually, Mr Nicholson says:

4 "This is where he is saying motor transport costs
5 are apportioned using analysis --"

6 I say:

7 "Precisely. Receiving the transfer charge from
8 BT Fleet management.

9 "So I just want to check, this phraseology, that
10 means that the actual cost of the trucks, in other words
11 the asset values and depreciation, are allocated to
12 different parts of the business that pay transfer
13 charges based on an assessment of their activities; is
14 that what is going on here?"

15 Over the page {Day3/88}:

16 "That is correct. So broadly speaking it is trying
17 to reflect the usage of the different divisions in terms
18 of the vehicles they use.

19 "So, for example, part of the actual costs of trucks
20 would be allocated to Openreach insofar as Openreach is
21 using those trucks?

22 "Yes, so if they use 50% of the trucks, they get 50%
23 of the cost type of thing."

24 So what Mr Nicholson is making very clear here was
25 that the actual cost of trucks to BT was being

1 allocated. You understand that?

2 A. Yes.

3 Q. It was being -- these truck costs would have been
4 recorded as capital costs; do you understand that too?

5 A. That is what Mr Nicholson says.

6 Q. Yes. Therefore BT would have been allowed to earn
7 a ROCE in respect of those costs; correct?

8 A. Yes.

9 Q. Yes.

10 Now, I will leave Mr Ward to cross-examine
11 Mr Bezant, but that is in fact what Mr Bezant has been
12 saying all along in relation to these matters.

13 The next issue I want to go on to is the
14 BT Supply Chain, which is the other disputed area, and
15 whether the amount of the putative overcharge incurred
16 by Openreach via BT Supply Chain should be included for
17 the purposes of the probability analysis.

18 Now, again, just thinking back to Mr Bezant's
19 diagram -- actually, we will call it up if we may,
20 {E/IC26/126}. No, I am sorry, that is the wrong
21 reference. {E/IC26/24}. I am so sorry.

22 I have just gone back to the diagram, Mr Harvey, you
23 are familiar with that, but I was just picking up, just
24 to resituate ourselves. We are dealing with,
25 essentially -- we have got DAF, BT Fleet, and then we

1 have got the four arrows coming off and we are dealing
2 with the second down, which is BT Supply Chain; yes?

3 A. Yes.

4 Q. Now, we know that BT Supply Chain provided certain
5 services to Openreach, do we not, and it used trucks to
6 do so; correct?

7 A. Yes.

8 Q. Yes.

9 It charged Openreach for those services, using
10 internal pricing transfer charges; correct?

11 A. Yes.

12 Q. Yes.

13 It is effectively the same sort of mechanism that
14 BT Fleet itself used to charge Openreach for trucks;
15 correct?

16 A. There are some differences in the way that Supply Chain
17 charged for its services.

18 Q. Well, let us deal with Supply Chain; it supplies to
19 Openreach specifically. You assume for the purposes of
20 your supply pass-on analysis that all of the putative
21 overcharge incurred by Supply Chain was passed on to
22 Openreach, do you not?

23 A. Yes, I do.

24 Q. Yes.

25 I think you caveat that, but it is quite hard to

1 square that with your position that the amount of any
2 putative overcharge passed on from Supply Chain should
3 not be taken into account for the purposes of
4 probability analysis, is it not?

5 A. I do not -- sorry, I think that is two slightly
6 different issues. One is taking account of Supply Chain
7 supplying Openreach; my probabilities do take account of
8 that issue. I think the thing we are concerned with is
9 whether return on capital employed should be added to
10 the costs before for Supply Chain.

11 Q. No, we are just looking at the Supply Chain recharges
12 here. The point we are concerned about is that, on your
13 analysis for supply pass-on, you say all the putative
14 overcharging cleared by Supply Chain was passed on to
15 Openreach, but then you do not take that into account
16 for the purposes of the probability analysis; that is
17 correct, is it not?

18 A. Yes, that is correct. In one of the scenarios
19 I calculated, I then took it into account in the second.

20 Q. Yes. We are really interested in, for the probability
21 analysis, the amount of any putative overcharge
22 allocated to Openreach in the RFS. I think we agree on
23 that; correct?

24 A. Yes.

25 Q. Now, we have already seen, I think, that the transfer

1 amounts recorded by each unit are replaced by the amount
2 of the actual cost underlying the charge. That was the
3 evidence I have just taken you through. You have seen
4 that?

5 A. Yes.

6 Q. So in the case of internal charges from BT Supply Chain
7 to Openreach, what the RFS is capturing is the amount of
8 actual truck costs underlying the charge, and that
9 actual truck cost is then allocated to Openreach. You
10 accept that?

11 A. If what Mr Nicholson says applies to Supply Chain, yes,
12 that would follow.

13 Q. Well, let us just go to -- I think it is entirely
14 covered, but just as an additional point, let us go to
15 {I6/221/29}, please.

16 Here we have -- this is back in the detailed
17 attribution methods document that we have already been
18 looking at. I am just trying to find ... we need to go
19 down further, please. I am not sure if we have the
20 right reference. Can you just bear with me one moment?

21 Can we just go back up the page again? So:

22 "A number of the individual methodology/base
23 descriptions set out in section 4 ... refer to the use
24 of an internal transfer charge destination as the basis
25 for attribution of the actual cost underlying the

1 transfer charge ... This section explains the rationale
2 for using this basis.

3 "The purpose of transfer charging is to:

4 "Enable customer-facing Divisions, who are
5 responsible for their own profitability, to receive
6 a correct allocation of income and expenditure.

7 "Enable support functions to charge for their
8 services to other group units."

9 Then, if we go down:

10 "Interbusiness transactions are accounted for on
11 a basis consistent with that for third parties external
12 to the BT Group and are subject to the same degree of
13 internal control. All transfers are supported by
14 written agreements between units ..."

15 Then, if we go down:

16 "Within the Accounting Separation ... process, the
17 transfer charge amounts recorded by each unit are
18 replaced with the actual cost underlying the charge, and
19 for which the charge is made. The actual cost is then
20 attributed consistent with the treatment of the transfer
21 charge."

22 Now, I do not think you have looked at this
23 document, have you?

24 A. No, I have looked at parts of this document. It is
25 a very long one.

1 Q. But have you looked at this bit?

2 A. Yes, I think I have.

3 Q. What is clear is that this confirms, does it not, it is
4 further documentary confirmation of what Mr Nicholson
5 said; correct?

6 A. Yes, I think it is.

7 Q. Yes, it is.

8 It is for the same reason that Mr Bezant also
9 applies the ROCE to the putative overcharge which
10 reaches Openreach through Supply Chain, is it not?

11 A. Yes.

12 Q. Yes.

13 So the actual truck costs allocated to Openreach for
14 capital costs, regardless of whether they reach
15 Openreach through internal charges levied by BT Fleet or
16 BT Supply; that is right, is it not?

17 A. That is consistent with the evidence of Mr Nicholson.

18 Q. Yes.

19 That, of course, has a significant impact on your
20 probability analysis, does it not, Mr Harvey?

21 A. Yes, it does.

22 Q. Yes.

23 Right. I am just going to move on to BT Retail now.

24 When I say a significant difference, on your own
25 analysis, it is more likely than not that there would be

1 a variation in glidepath control; that is correct, is it
2 not?

3 A. It is, and that is what my report shows.

4 Q. Let us move on to BT Retail.

5 It is right that BT did not provide disclosure in
6 relation to BT Retail; you know that, do you not?

7 A. Yes.

8 Q. Instead, BT provided something of a high-level pricing
9 statement; that is correct?

10 A. Yes.

11 Q. Just for the tribunal's benefit, it is referred to as
12 a statement from BT Consumer, but BT Consumer is just
13 the name of what BT Retail used to be; it does not make
14 any difference.

15 Could we just go to it? {C/IC19.1.8} I think. Is
16 that right? Or is it 19.1? Yes, I think it is
17 {C/IC19.1/1}.

18 So this is the pricing statement and I just want to
19 go to paragraph 30, which is on page 8 [sic].
20 {C/IC19.1/10}, which is why my notes were wrong. Sorry.

21 This explains that BT Retail was subject to price
22 caps between 1997 and 2006. You recall this?

23 A. Yes.

24 Q. Then if we go on to paragraph 31 {C/IC19.1/11}, it
25 explains that BT Retail would have priced up to the cap.

1 Do you see that?

2 A. Yes.

3 Q. So we know, do we not, that if the price caps had been
4 lower in the counterfactual, then BT Retail's prices
5 would have been lower too; correct?

6 A. If the price caps had been lower, yes.

7 Q. Yes.

8 We also know, do we not, that the regulator's
9 overall approach until 2002 was similar to the approach
10 that we have discussed in some detail, there were
11 glidepath controls, and BT was allowed to recover its
12 forecast efficient cost, plus a ROCE; correct?

13 A. Yes, and those are considered in the regulation part of
14 my report.

15 Q. Yes.

16 So in the circumstances, it is reasonable, is it
17 not, for Mr Bezant to proceed on the same basis as he
18 has done in relation to Openreach, is it not, in
19 relation to BT Retail?

20 A. For these products.

21 Q. For products not subject to regulation and for the
22 period after 2006, Mr Bezant emphasises the fact that BT
23 Retail was competing against other communication
24 providers, almost all of whom purchased inputs from
25 Openreach; that is correct, is it not?

- 1 A. Yes.
- 2 Q. Yes, and you would agree with the general point,
3 would you not, that the vast majority of the market used
4 Openreach services as inputs; correct?
- 5 A. Yes.
- 6 Q. You would also agree, would you not, that in
7 circumstances where there is an increase in common cost,
8 then it is likely that they would probably all pass it
9 on in those circumstances?
- 10 A. No, that depends on how competition in that market works
11 and also how they go about setting their prices and
12 whether they use rounded figures.
- 13 MR BEARD: I have no further questions for Mr Harvey in
14 relation to supply pass-on. We will be meeting again
15 next week for further cross-examination, but for the
16 moment I do not have anything else.
- 17 THE CHAIRMAN: All right, yes. Excellent. We need to keep
18 a note of the time you have had.
- 19 MR BEARD: Yes.
- 20 THE CHAIRMAN: I think it is three and a half hours?
- 21 MR BEARD: Yes, it has been noted. I did not make the same
22 mistake I did the other week where I forgot that we
23 started at 10 o'clock, so I have been bearing these
24 things in mind.
- 25 A. I have not forgotten that.

1 MR BEARD: Sorry, Mr Harvey. I was having too much fun.

2 THE CHAIRMAN: Any re-examination?

3 MR WARD: No, thank you, sir.

4 Questions by THE TRIBUNAL

5 MR RIDYARD: A couple of questions, Mr Harvey.

6 First of all, on the discussion earlier on, about
7 the distinction between leased trucks and purchased
8 trucks, can you just tell us what difference it makes
9 whether they are classified as leased rather than
10 purchased to the pass-through analysis?

11 A. Yes. When trucks are purchased as outright purchase,
12 they are treated by the regulator as a capital cost and
13 included in the regulatory asset base. So in principle,
14 if that sum changes in the counterfactual, it would
15 attract a different level of allowed profit.

16 I will go round that again, because it did not come
17 out quite as I hoped. So if you have an amount of
18 a truck, including the regulatory asset base, anything
19 in the regulatory asset base gets a cost of capital
20 allowance, whereas if it is an operating expense, then
21 it does not.

22 MR RIDYARD: Purely a current cost, yes.

23 A. Yes, exactly. So that is the main reason for the
24 distinction between the two matters.

25 MR RIDYARD: Yes.

1 The second question was just about -- it has sort of
2 come up in both the Royal Mail and the BT discussion,
3 and it is a question of -- you make the point that you
4 might not get sort of pass-through because -- well, for
5 various reasons, but one of them being the sort of --
6 the indivisibility, if you like, of the pricing. So
7 even if you wanted to pass through a certain amount of
8 cost, the extreme example would be the stamp price, you
9 would not put 0.001p on a stamp price, so either it has
10 to go up by 1p or nothing at all.

11 A. Yes.

12 MR RIDYARD: So that, in your argument, reduces the
13 pass-through thing.

14 But, of course, you were taken both in the
15 Royal Mail and the BT cases to possible ways in which,
16 in certain parts of the price cap or certain individual
17 glidepaths or whatever, there would be scope for passing
18 through relatively small amounts in the scheme of
19 things, such as the infringement overcharge.

20 I just wondered, in both the cases of Royal Mail and
21 BT, is it the case that the companies would have
22 discretion about where they decided to recover the cost
23 of the overcharge through pricing? So could they
24 squeeze -- if there was a set amount of overcharge,
25 could it be squeezed out of any bit of the business or

1 would it need to be -- if it was going to be passed
2 through, would it need to be passed through kind of
3 pro rata to the different bits of the business? Do you
4 have a view on that?

5 A. Yes, so they do not have unfettered discretion because
6 of the way the price control -- one reason is because of
7 the way the price control works. I think Mr Beard
8 referred to the two baskets in the case of Royal Mail.

9 But in the case of BT, obviously the regulator is
10 concerned with the price of the product reflecting the
11 costs of that product. So, in both cases, they do not
12 have unlimited ability to move the truck -- if you like,
13 if you fail through one product, you do not necessarily
14 get the opportunity to recover it in another product.
15 So that is the regulatory end, and the circumstances are
16 a bit different, as I said, between Royal Mail and BT.

17 Then, in terms of the way the companies look at
18 costs, they do typically allocate costs to products, and
19 so I do not think it necessarily follows that if you
20 sort of think you would like to recover the costs
21 somewhere else for whatever reason, it is not obvious
22 that they are set up in a way that would actually do
23 that. They allocate the costs to particular products.

24 MR RIDYARD: Are those constraints -- are they -- have you
25 discussed those in your report? Is that fully set out?

1 A. The regulatory constraints are discussed in my report.
2 I think it would be fair to say that Mr Bezant discusses
3 more of the internal costing and pricing processes in
4 his report and how they allocate costs, but there is
5 a commentary in both.

6 MR RIDYARD: Thank you.

7 MR BEARD: It does not matter for now. I mean, I would
8 otherwise be challenging what Mr Harvey was saying in
9 relation to that, but since Mr Bezant is no doubt going
10 to be cross-examined in relation to that, I am very
11 happy to leave it.

12 THE CHAIRMAN: All right. So I think that is it for this
13 further round. Thank you very much, Mr Harvey.

14 A. Thank you.

15 THE CHAIRMAN: You are released until next week.

16 (The witness withdrew)

17 Before we carry on, was there any resolution to the
18 issue of loss of volume and how we are going to deal
19 with that?

20 MR BEARD: The issue with loss of volume, being candid, is
21 that there is a danger with loss of volume
22 cross-examination, if it is covering things thoroughly,
23 taking rather longer than the possibility of dealing
24 with things through a hot tub, because of the way that
25 cross-examination has to build things up. So what we

1 have been trying to do is to have a discussion about
2 whether or not there could be a limitation on the sort
3 of topics that fall for cross-examination.

4 I think that is still going on. I think the latest
5 iteration was I saw a letter from Mr Ward's solicitors
6 making some suggestions that we have not managed to
7 respond to yet, partly because I was --

8 THE CHAIRMAN: I think we need to resolve this probably by
9 tomorrow morning.

10 MR BEARD: Yes. The options would be for there to be
11 essentially a hot tub, which is not necessarily led by
12 the tribunal so the burden does not fall on it, but
13 there are general topics on which the experts comment,
14 and then some more limited cross-examination, or we try
15 and narrow the cross-examination, because otherwise
16 I think both Mr Ward and I probably have concerns about
17 how efficiently it is going to be dealt with. Obviously
18 I will leave Mr Ward to speak for himself, but it may
19 well be -- the problem with cross-examination, sir, as
20 you well know, is that, in order to work your way
21 through to particular propositions, it can take rather
22 longer than when neutral questions are asked of
23 witnesses in relation to these topics. So I think that
24 is one of the underlying concerns that exists here.

25 THE CHAIRMAN: All right. Yes, I mean, if you think it is

1 going to be a more efficient use of time for there to be
2 a hot tub --

3 MR BEARD: Yes.

4 THE CHAIRMAN: -- then we are happy to do it.

5 MR BEARD: Oh, okay. We had not understood that to be the
6 case so --

7 THE CHAIRMAN: Well, I think we were just concerned about
8 the amount of time that was proposed to be spent on loss
9 of volume --

10 MR BEARD: Yes.

11 THE CHAIRMAN: -- when it is a relatively minor part of the
12 case.

13 MR BEARD: As I indicated the other day, it is because of
14 those concerns about the proportionality of getting
15 involved in cross-examination that actually there is
16 some discussion been going on. But I think, with that
17 indication, I will leave it to Mr Ward, but we might
18 revisit things this evening.

19 THE CHAIRMAN: All right. So maybe we will confirm that
20 tomorrow morning, but, you know, we are happy to do it.
21 If everyone thinks that that is the most efficient way
22 of dealing with it, then we will do that.

23 MR WARD: As Mr Beard says, we have written a letter
24 proposing a narrowing of the issues, because there are
25 some supposed issues in it that really do not have any

1 true financial bearing. So if we can -- let us see
2 where we get to -- and it is no criticism whatsoever
3 that we have not had a reply -- let DAF consider it, and
4 then we can come back to you in the morning and see
5 where we are up to.

6 THE CHAIRMAN: All right. Thank you. Okay, so Mr Bezant.

7 MR MARK BEZANT (affirmed)

8 THE CHAIRMAN: Mr Bezant, please sit down. Make yourself
9 comfortable.

10 A. Thank you.

11 THE CHAIRMAN: You are new to the witness box in this case,
12 so ... I do not know whether you have got hard copy
13 bundles at all? No?

14 A. I am hoping they are all over here.

15 MR BEARD: I think some hard copy bundles may well be
16 arriving shortly.

17 THE CHAIRMAN: Winging their way over. Okay. You will also
18 have the documents on screen, but I am sure you have
19 been following it that way.

20 Okay.

21 MR BEARD: The hard copies will be arriving with you
22 shortly. I am sure both of those are -- great. If at
23 any point you want to go to a hard copy version of
24 a document, I am sure you can ask Mr Ward and they will
25 give electronic versions.

1 A. I prefer hard copy generally, but I appreciate that
2 might not be practical always.

3 MR BEARD: Okay. Now --

4 A. Thank you.

5 MR BEARD: I do not want to be unduly casual with the
6 introduction of Mr Bezant as a witness. There are -- as
7 with Mr Harvey, there are in fact six expert reports and
8 a joint statement. I can take him to each of them, but
9 I can equally just ask him whether he has provided six
10 expert reports and signed a joint statement? I will do
11 that.

12 Examination-in-chief by MR BEARD

13 So, Mr Bezant, you have provided six reports, three
14 in relation to Royal Mail, three in relation to BT, and
15 signed joint statements in relation to both Royal Mail
16 and BT. Are those true to the best of your knowledge
17 and belief?

18 A. They are.

19 MR BEARD: I do not have any questions for you. Mr Ward
20 will do, and then the tribunal may have some.

21 A. Thank you.

22 THE CHAIRMAN: Mr Ward.

23 Cross-examination by MR WARD

24 MR WARD: Thank you.

25 Good afternoon, Mr Bezant.

1 A. Good afternoon.

2 Q. I hear, very noisily, some hard copies are arriving.

3 You might want them a little nearer to hand than that

4 I suspect.

5 A. Yes --

6 Q. Why do you not move them to where would be comfortable

7 for you.

8 A. Can I put some of Mr Harvey's reports away and then

9 I can put mine --

10 Q. Good idea.

11 A. Thank you.

12 Q. This really is not a job for you but thanks very much.

13 A. Right, apologies.

14 Q. No. Apologies from us. Thank you very much.

15 I am going to try to give electronic references but

16 also to give you a tab reference to where they should be

17 in the blue bundles that you have.

18 I want to start with the question of counterfactual

19 analysis, because you and Mr Harvey did agree that what

20 you were trying to perform was counterfactual analysis;

21 yes?

22 A. That is correct.

23 Q. The way you formulated it on the basis of your

24 instructions was whether Royal Mail or BT's prices would

25 have been lower absent the overcharge.

- 1 A. That is correct.
- 2 Q. Would you accept that that is the same question as
3 whether, in the factual scenario, the overcharge caused
4 prices to be higher than they would otherwise have been?
- 5 A. Yes, I think I would. From my perspective, obviously,
6 I think I would. As an accountant I would, yes.
- 7 Q. Thank you. Obviously I am not asking you about legal
8 questions.
- 9 A. Yes.
- 10 Q. I am going to just ask you first about some general
11 themes in your evidence, and then we will look briefly
12 at Royal Mail, and then, almost certainly tomorrow, the
13 BT regulatory instruments, but firstly, just some
14 general themes.
- 15 Now, the first is that you place a lot of emphasis
16 on the nature of cost controls by the business and
17 the methods of allocation to individual products and
18 within the business.
- 19 A. I place a lot of emphasis on the processes --
- 20 Q. Yes.
- 21 A. -- by which costs were captured, measured and allocated
22 in the context of setting prices and managing the
23 business overall.
- 24 Q. Would you agree that the question of cost allocation is
25 separate to one as to whether those cost increases

- 1 actually increased the prices?
- 2 A. Sorry, could you say that again?
- 3 Q. Yes. So we have a question of cost allocation within
- 4 the business, but there is a further and separate
- 5 question whether the allocation of costs actually caused
- 6 prices to be higher?
- 7 A. Yes, I agree with that, although, again, I think
- 8 movements in cost can sometimes lead directly to an
- 9 increase in prices. Sometimes it can lead to the
- 10 expectation of an increase in price. It depends on the
- 11 context.
- 12 Q. Or sometimes may not lead to an increase in price at
- 13 all?
- 14 A. Correct.
- 15 Q. Now, I think it is common ground that truck costs
- 16 specifically are not considered separately as part of
- 17 cost allocation or price setting for either Royal Mail
- 18 or BT?
- 19 A. I am not sure I would agree with that. They are
- 20 considered separately because, like with all costs, they
- 21 need to be incorporated into cost allocation mechanisms
- 22 and systems. Whether they are separately reported at
- 23 some level of abstraction within that process is
- 24 a different point, but they have to be included because
- 25 they are one of the body of costs incurred by the

1 company.

2 Q. Yes, it is a slightly separate point. If I may, can
3 I just show you, if you go to your tab 7 and we go to
4 {E/83/15}, we will see why I hoped this was common
5 ground. This is the Royal Mail joint expert statement.

6 A. Could you just repeat the --

7 Q. Yes, so your tab 7, page 15. B.5.4 on the right, it
8 says:

9 "Mr Bezant has not identified evidence showing an
10 explicit consideration of 'Truck costs' (or indeed many
11 other potential specific categories of cost) in
12 [Royal Mail's] pricing mechanisms."

13 A. In the explicit pricing mechanisms, no, but I was
14 talking about them being -- I thought you had asked me
15 about costs, being part of the costing systems?

16 Q. No, no. I asked you about whether the truck cost was
17 specifically considered in the cost allocation or price
18 setting?

19 A. Well, you said "cost allocation or price setting" --

20 Q. Yes.

21 A. -- so I was talking about cost allocation.

22 Q. Well, let us talk about that. Firstly, in Royal Mail,
23 we know that within the cost allocation system, they
24 have a category of vehicle costs, do they not?

25 A. They do.

1 Q. Mr Devine explained that the vast majority of vehicles
2 were vans and that the vehicle cost element included
3 depreciation, fuel and maintenance. Do you recall this
4 or would you like to see it?

5 A. I do.

6 Q. He also said there was no way of showing how much of
7 those charges were capital costs. It is not a memory
8 test; I can just show you if it would help.

9 A. If that is what he said, I will accept that.

10 Q. Then, for BT, there was a category of motor transport
11 costs, which also included depreciation, non-capital
12 costs such as maintenance and fuel, and Mr Harvey
13 estimated that trucks in the claim were about 10% of the
14 fleet. Do you recall that?

15 A. I do not recall that, but I am fine with that estimate.

16 Q. So would you accept that in each case, when we look at
17 those categories within the cost allocation system, we
18 cannot say exactly how much relates to the kind of truck
19 capital costs we are interested in?

20 A. When you look at it at that level of reporting or
21 presentation you do not see trucks. But my point was,
22 from the way costs are built up and allocated in a very
23 precise way, then they are included. They may not be
24 separately identified, but they are included.

25 Q. We are not disagreeing over that, Mr Bezant, we are

1 looking at the question of whether, when we look at that
2 allocation system, we can actually see, from the way
3 costs are allocated, how much is the truck cost. My
4 point is that these categories are broader than that.

5 A. The categories are broader, but the categories are
6 aggregations of underlying costs --

7 Q. Yes, indeed.

8 A. -- depreciation on vehicles, for example, and to the
9 extent trucks are in there, then depreciation on trucks
10 is in there. It is a question of presentation of an
11 aggregated cost or cost type rather than the exclusion
12 of a cost.

13 Q. But what we are doing here, what has happened in this
14 case is an attempt to trace through not just the truck
15 cost, but actually the overcharge element in the truck
16 cost, through cost allocation and all the way into final
17 prices, is it not?

18 A. Yes, and the overcharge is embedded within the truck
19 cost, and hence the treatment of the truck cost as it
20 flows through the system.

21 Q. For each claimant, there are a whole series of steps,
22 are there not, before -- to get from the purchase of the
23 truck through to the unit that actually sets the prices?

24 A. Yes, there is very detailed mechanisms to allocate costs
25 causally.

1 Q. Sometimes there might be more than one step: so it might
2 start with BT Fleet, go to Supply Chain, go to
3 Openreach, Openreach to a retail unit, and then on to
4 the final customer?

5 A. Yes, these are complicated businesses and you have to
6 trace the cost through the system.

7 Q. Would you accept that these kind of cost allocation
8 exercises involve the application of judgment and indeed
9 sometimes estimation?

10 A. The cost allocations do involve judgment, for example,
11 how much a particular product uses a particular
12 resource, but once those judgments are made, then the
13 cost flows through the system.

14 Q. So to determine how much truck cost went into
15 a particular product, say, would involve some element of
16 estimation and some assumptions?

17 A. Yes, in the way that I said. If product A uses a truck
18 X% of the time or X% of a truck, that would be
19 a judgment that would be made, a judgment would be --
20 the judgment made in the actual judgment would be the
21 judgment made in the counterfactual. If a truck costs
22 you more, it does not mean you can drive it less; you
23 have to use it to the same extent.

24 Q. Now, I want to talk about the relevance of cost recovery
25 and profitability, in general. You have relied on the

1 fact that BT and Royal Mail sought to, and indeed in
2 various periods succeeded in making a profit and
3 recovering their costs. I will just show you an example
4 of the kind of thing I am talking about, and this is in
5 your tab 2.1 at page 117, and it is {E/19/117}, please.

6 A. I am so sorry, you are going a little fast with the
7 references.

8 Q. I am so sorry. 2.1 for you. Then, if we have
9 {E/19/117}.

10 This is actually dealing with Royal Mail profits
11 from non-regulated mail activities during the whole
12 Postcomm period, from 2002 to 2012.

13 We can see, in the last column, "Profit margin", and
14 there are losses made in some years, but profits made in
15 most, and you have aggregated those together to reach
16 a conclusion that 12.12:

17 "This indicates that Royal Mail recovered its costs
18 (including Truck costs) allocated to non-regulated
19 products in total over the 2001-12 Postcomm Period."

20 So you have aggregated some where there were losses
21 and done a sort of netting exercise.

22 "That is, in respect of non-regulated products,
23 Royal Mail successfully set its prices so as to recover
24 all of its costs and earn a profit in total over the
25 period."

1 Now, you make frequent mentions indeed in your
2 evidence of prices being set to recover costs or, to use
3 other language you use a lot, strong relationship
4 between costs and prices, so on average higher costs
5 resulted in higher prices.

6 Now, would you accept as a general proposition that
7 the fact a business recovers its costs does not
8 demonstrate that a particular cost increase caused its
9 prices to be higher?

10 A. Sorry, say that again, please?

11 Q. Yes, sure.

12 A. Thank you.

13 Q. So a business recovers its costs. It may have a cost
14 increase, but even if it afterwards still recovers its
15 costs, that does not mean its prices have actually gone
16 up.

17 Let me try an example. I do not mean to be baffling
18 abstract. Suppose a TV manufacturer has a margin of
19 £100 and it incorporates screens made by a third party,
20 and the third party increases those costs by £50. If
21 the price of the TVs remains the same, you would still
22 have cost recovery, but there would not have been any
23 increase in prices.

24 A. There would not have been any increase in prices in that
25 example, I agree with you.

- 1 Q. So the point I am making, and I am sorry if it was not
2 easy as expressed, is simply that cost recovery on its
3 own tells you nothing about whether prices were
4 increased because of a cost increase?
- 5 A. Cost recovery as an objective and as a basis for the way
6 that you organise your affairs and set your prices, and
7 cost recovery as an outcome through profits can tell you
8 something about the extent to which you were trying to
9 recover your costs and, over the long haul, you have
10 recovered your costs. It is not determinative, but
11 I think it is informative.
- 12 Q. But in particular it would not tell you whether any
13 particular cost increase had actually caused an increase
14 in prices?
- 15 A. In isolation, no, but as a guide, particularly over the
16 longer period, to whether you were recovering your costs
17 and the changes in your costs over that period in all of
18 their different ways, and it would tell you something,
19 I think, particularly when you do not have a lot of
20 information, about the business' endeavours, actions and
21 success, or otherwise, in recovering all of its costs,
22 of which you may be interested in one of them.
- 23 Q. It might tell you something, but it would be something
24 broad, would it not?
- 25 A. I think -- well, I do not know what the word "broad"

1 means here. I think it would help, it would inform,
2 which is why I looked at the exercise.

3 Q. But if, as we are going to come on to, the cost increase
4 in question was very, very small relative to the
5 business' overall costs, it might not actually tell you
6 anything useful at all?

7 A. It -- well, it depends what else you have available to
8 you.

9 Q. Indeed.

10 A. So, as I said, where there is limited information, you
11 I think are forced to look at more general activities
12 and endeavours and incentives and objectives and
13 outcomes because you do not have information at a more
14 detailed level. That has tended to be how I have used
15 it.

16 Q. Indeed, and I am going to come on and look at a bit more
17 of the detail, but I will just take the opportunity to
18 put my case, that given how small these increases are,
19 it cannot tell you anything in this case about whether
20 the cost increase of overcharge caused prices to rise?

21 A. I think it is -- and in my reports I have identified the
22 uncertainty surrounding some of these questions where
23 the information is limited, so I have identified why
24 I believe my best estimate is the way it is, because of
25 the way they conducted their affairs, but I recognise

1 the uncertainty associated with that.

2 Q. Let us look at another example further on in the same
3 report. This is on page 132 {E/19/132}. This is
4 a scatter chart. This is a scatter chart, this is
5 Royal Mail in the unregulated period, the Ofcom period,
6 2012 onwards. You have got quite a few scatter charts
7 like this through your reports, I am just using this as
8 an example. You have "Unit FAC" along the bottom and
9 you have "Price" along the top. You say:

10 "On this basis ..."

11 There is a bit more reasoning which I will come to
12 in a moment but:

13 "On this basis, my best estimate of supply pass-on
14 ... is ... 100%. This is consistent with the simple
15 linear regression analysis that I have been able to
16 perform with the data available."

17 I just want to see if we can agree what this chart
18 actually shows. Would you accept that it does show
19 there is a relationship here between the cost and the
20 FAC, that on average more costly products are more
21 expensive?

22 A. Yes, and they tend to rise, as you said, from left to
23 right, as the costs allocated to a product goes up, the
24 price of a product goes up.

25 Q. If we look at the dots on the scatter chart, we can also

1 see very widely divergent prices with the same FAC. So
2 we can see, for example, at around a FAC of 600-ish, we
3 have prices ranging from about 260 up to about 760, just
4 as an example?

5 A. So, one would need to -- I agree that there are, for
6 a given level of costs, there may be different prices
7 for different products, that may reflect something about
8 differences between individual products, but that does
9 not affect the underlying relationship that as costs
10 increase or decrease, prices increase or decrease in
11 this chart.

12 Q. But what I am also suggesting is what this shows is
13 there is not a close relationship here between price and
14 FAC that would let us -- tell us that a very small
15 increase in FAC would drive a price increase itself?

16 A. Well, I think in general terms, the extent to which
17 costs are linked to prices, in the sense that one is
18 trying to achieve a price that recovers one's costs and
19 one is trying to react to changes in prices for all the
20 reasons that are being discussed, then changes in prices
21 over time and between products do tend to lead to --
22 sorry, changes in costs, excuse me, do tend to lead to
23 changes in prices. It is not determinative, I have said
24 that to you before, but I think it is informative of the
25 underlying relationship between the cost of a product

1 and the price of a product.

2 Q. Informative, but in my suggestion to you, it will not
3 help us decide whether these tiny, tiny cost increases
4 actually were passed on.

5 A. Well, I cannot anticipate what the tribunal will take
6 into account, but to the extent one is trying to
7 understand the processes, the objectives, the
8 incentives, the relationships between costs and prices
9 and the way the business manages its affairs in order to
10 recover its costs, make a profit and so on, I think
11 these kinds of relationships tell you what they were
12 trying to do and what would have tried to do with
13 a different set of costs. Because that is what they are
14 trying to do each and every year with a different set of
15 costs.

16 Q. I will just show you what the build-up is of your
17 reasoning here, if we go back to page 130 {E/19/130}.
18 This is your conclusion that there was 100% pass-on for
19 this post-2012 period. You have got three propositions.
20 The first one is:

21 "Royal Mail's focus on profitability ..."

22 I have already put to you I would not accept that
23 that tells you anything about pass-on in this case.

24 The second one is whether there was already
25 overcharge in the system from the previous regulatory

1 period. We will come back to that.

2 But then, the third one is the relationship between
3 price and unit FAC, and you say:

4 "Using this data ..."

5 Last four lines --

6 THE CHAIRMAN: Do you need to go on a page {E/19/131}?

7 MR WARD: I am sorry? Oh, yes, sorry. My mistake.

8 "The relationship between price and unit FAC in
9 2014/15 for Royal Mail's access products and
10 retail-equivalent products [which is the scatter chart]
11 ... Using this data and a simple linear regression model
12 results in a coefficient ... of 0.97. That is, all else
13 being equal, a £1 increase in FAC would result in
14 a £0.97 increase in price. This simple analysis implies
15 a Supply Pass-on rate of around 100%."

16 What I am suggesting to you is this simple analysis,
17 to use your words, cannot begin to tell us whether in
18 fact overcharge itself was passed on. Would you accept
19 that?

20 A. The analysis in isolation, no; the analysis in
21 combination, particularly if there has been a roll
22 forward from the PC3 --

23 Q. I will come back to that later.

24 A. If there has been a roll forward -- so I have three
25 reasons here. We have been talking about the general

1 relationship between fully allocated costs and prices,
2 which was persistent in the period, because I have used
3 something some way into the Ofcom period. I am also
4 talking about to the extent there had been an overcharge
5 in the PC3 period, that it carried through into the
6 opening prices in Ofcom, and in the counterfactual, if
7 there had been lower prices, that would have carried
8 forward into the Ofcom period. So it is the three
9 things in combination, I am saying about 100%.

10 Q. Let us look at that roll forward while we are here. If
11 we could, please, go to tab 5, which is Mr Harvey's
12 third report. Of course, Mr Harvey --

13 A. Can I just get the hard copy?

14 Q. I think you are in the right bundle already.

15 A. Oh, sorry.

16 THE CHAIRMAN: Can you give a reference to the electronic?

17 MR WARD: It is {E/57}, please. It is page -- I am so
18 sorry, I have not actually got the page number. Just
19 give me a moment, I will find it. It is page 62
20 {E/57/62}.

21 This is dealing with your point about roll forward.
22 Of course, the first point we make is of course
23 Mr Harvey does not think there was any pass-through in
24 the previous period, but let us assume he is wrong about
25 that, otherwise this becomes academic. Here at 9.6, he

1 actually quotes from your evidence that Royal Mail
2 implemented significant price increases once it was
3 granted commercial freedom to set prices, for example,
4 in 2012/13, it aimed to generate an extra 250 million
5 cashflow through higher prices on the basis it would
6 improve profitability and strengthen the case for an
7 earlier initial public offering, and also Royal Mail's
8 evidence that it was heavily constrained. So it is not
9 by any means automatic, is it, that prices were just
10 pegged to what had been previously allowed by Postcomm
11 once the shackles of Postcomm were taken off?

12 A. So, the prices -- so there was, obviously, a change in
13 the regime, there was a loosening of the oversight. But
14 to the extent to which the opening prices had been lower
15 because the opening costs had been lower, that is the
16 environment you start with, whether that needed to be
17 bolstered by another 250 million still does not mean
18 that you do not come into that period with lower prices.
19 There is no reason to believe if you had come into that
20 period with lower prices, because you had come into that
21 period with lower costs, you would not still need the
22 250.

23 So that, in a sense, does not tell you anything
24 other than you would have come into the period with
25 lower prices.

- 1 Q. You are setting new prices now, that is the point?
- 2 A. But the prices you would start with are lower than they
3 would otherwise be. You would not have a reason to
4 increase them by 253 million because you do not need to,
5 because your profits -- because your costs were lower,
6 you still need the 250, for example; you do not need
7 more than 250.
- 8 Q. What I am putting to you is if there is a large scale
9 repricing of this kind, that really just breaks the
10 chain between what was the regulated price and what
11 became the deregulated price.
- 12 A. So, there was a chain -- so the -- to use your
13 terminology, the chain breaks the chain, but you are
14 still starting from a different lower set of prices
15 because you have a different lower set of costs. So you
16 will need to make -- to increase prices to recover the
17 ground, if you have been unprofitable, starting from
18 a lower position. The fact that you need --
- 19 Q. I have put my case on this. I fear we might be going
20 round in circles, and whether that is my fault I am not
21 sure, but let us --
- 22 A. I do not think it changes my analysis, the fact that
23 you, in the Ofcom period, may need to catch up because
24 the PC3 period was a period that they did not achieve
25 full recovery of cost or the profit margins. The point

1 is, when you enter that period, your prices are lower,
2 your costs are lower. You are reacting to that, but
3 your prices and costs are still lower.

4 Q. Well, my point, I will put it one more time and hope it
5 is a bit clearer. The short point is, you are setting
6 prices afresh in the deregulated era; it is not being
7 driven by the constraints of Postcomm and whatever
8 Postcomm did or did not allow you to recover?

9 A. But you are setting prices afresh by reference to
10 a lower set of costs, because if there had been no
11 overcharge, you have a lower set of costs, which is why
12 you have a lower set of prices. So you are not setting
13 them afresh -- setting them afresh from a different --
14 a lower position, that does not mean that you set them
15 back to where they were in the actual world if they
16 start from a different point in the counterfactual
17 world.

18 Q. Where they were set was where Postcomm allowed them.
19 Let us move on.

20 THE CHAIRMAN: I am a little confused as to whether you are
21 talking about -- you are putting questions to him in the
22 counterfactual or in the actual.

23 MR WARD: I was actually putting them in the actual, but
24 Mr Bezant started talking about the counterfactual.

25 THE CHAIRMAN: Right.

1 MR WARD: I feel I have put my case sufficiently and we will
2 move on, because there is a slight lack of communication
3 going on here I think.

4 THE CHAIRMAN: Okay. Well, if you do not want to clarify
5 that?

6 MR WARD: Let me try one more time.

7 The point I am making is in the actual, not the
8 counterfactual --

9 A. Right.

10 Q. Thank you, sir, it probably is helpful to clarify.

11 In the actual, Royal Mail is free of Postcomm
12 regulation, hurrah, in 2012, and has the light touch
13 regime of Ofcom. As your evidence makes clear, it then
14 decides what it needs to do is put prices up to recover
15 more money, because, of course, it has had frankly
16 a disastrous period in PC3 and has not been able to
17 recover its costs, as we know and we will come back to.

18 A. So, in the actual world, it puts its prices up, or it
19 wishes to put its prices up in the regime operated by
20 Ofcom. I agree with you, yes.

21 The question that I have been addressing is what
22 would have been different. Because in
23 a counterfactual --

24 Q. We might be at slightly cross-purposes in terms of what
25 we are talking about here. What I am trying to

1 establish, and failing horribly, is that the -- whatever
2 the constraints on the prices were from the Postcomm
3 period can then be regarded as at an end. So the issue
4 that you have raised is that if there was pass-on in the
5 Postcomm period, then we can infer that it somehow
6 continued into the Ofcom period.

7 What I am suggesting is it is just a complete reset
8 and the Postcomm period does not tell us anything
9 informative.

10 A. Well, I do not agree with that, because what carries in,
11 and this is why you have to look at -- so, in the actual
12 world, you deal with the actual position: costs were
13 here. Right? Therefore you wish to reset in an Ofcom
14 world as best you can.

15 In the counterfactual world, costs and prices, if
16 there has been pass-on, are different, and you reset
17 from there. But the reset is by reference to where you
18 find yourself. It is not by reference to the actual, it
19 is by reference to the counterfactual in the
20 counterfactual, which is why I say it carries in, in the
21 counterfactual, from where you start in the
22 counterfactual.

23 Q. So, just for the transcript, you were showing your hands
24 a sort of foot or so apart from the counterfactual and
25 the real world in terms of what the gap was. We are

1 going to come on to the scale in a minute, but the point
2 I am making is that you have this argument that price
3 setting was finely calibrated by Postcomm to actual
4 cost. Suddenly, we are in the post -- the world beyond
5 Postcomm and we have got no reason to think these price
6 changes were highly calibrated to very small elements of
7 cost?

8 A. I think I agree with that, but the price changes in the
9 counterfactual are calibrated to where you start from.

10 Q. Fine. Well, we can definitely move on on that basis.

11 I want to now talk about, a bit more precisely, what
12 we have talked about vaguely, which is the scale of the
13 overcharge, which did not really feature in Mr Beard's
14 questioning this morning.

15 Now, we know that in broad terms Royal Mail's
16 revenues are around 10 billion and BT's revenues are
17 around 20 billion, in very broad terms. In terms of the
18 overcharge, in Royal Mail's case, it is around
19 £30 million for the entire period of the claim, not for
20 a particular year. You will have seen that Mr Harvey
21 has estimated that, for the Royal Mail brand, the
22 overcharge never exceeded 0.05% of the relevant revenue
23 in any year. Indeed, it was as low as 0.001. You have
24 seen those figures?

25 A. I have.

1 Q. For BT, the overcharge is even smaller in relative
2 terms, because we are considering a total overcharge of
3 £4.7 million over the entire period. We know that
4 Openreach and Supply Chain, which use most of the
5 trucks, had annual revenues, just for an example, in
6 2015/16, of £5.2 billion; yes? These figures are
7 familiar.

8 So even in the case of Openreach, which we agree is
9 the most important for this purpose, Mr Harvey has
10 estimated the overcharge was worth less than 0.003% of
11 its revenues over the entire period. You have seen
12 those figures?

13 A. I have.

14 Q. Also, in each case, the companies in question had
15 a large number of products, some of which, like stamps
16 or some of the telecoms products, had very low nominal
17 amounts, very low sticker prices if you like; yes?

18 A. Yes.

19 Q. In the case of Royal Mail, for example, it sold around
20 22 billion different items in 2003/4. Not different
21 product lines, but total sales. 22 billion; yes?

22 A. I am not familiar with the number, but I will not
23 dispute it obviously.

24 Q. Okay. Well, it comes from the RFS for 2003/2004.

25 So would you accept that what we are looking for

1 here is an actual effect on pricing arising from these
2 tiny increases that we are really looking for a needle
3 in a haystack, are we not?

4 A. We are looking for the effect of a different lower set
5 of costs on the way that prices resulted.

6 Q. So we are looking for the effect of a tiny, tiny, tiny
7 change in costs in relative terms on product prices
8 across a whole range of products, are we not?

9 A. It is a small change in total costs, but the issue is,
10 with a different set of total costs, when you put them
11 into these systems to work out costs, cost allocations,
12 prices, what would have been the result? It is still
13 a large set of costs and it still gets processed, if
14 I can put it like that, in the same way. The question
15 is what effect it has, not that it is a small
16 difference, but what effect using a different set of
17 costs has.

18 Q. Let me show you what you say about this in the joint
19 expert statement, which is -- you say the same thing in
20 both Royal Mail and BT, but we can go to tab 7 in your
21 bundle, page 83 -- sorry, tab 83 -- sorry {E/83/19}.
22 That is it, thank you. Tab 7.

23 A. Sorry, can you give me the page number again?

24 Q. It is page 19.

25 A. 1-9.

1 Q. Have you got that?

2 A. I do, thank you.

3 Q. You say under "Disagree" -- and when it says "Mr Bezant
4 considers" that is you writing in the third person,
5 is it?

6 A. Yes.

7 Q. "... considers that there is no inherent (or necessary)
8 relationship between the size of the alleged Overcharge
9 and any conclusions in relation to Supply Pass-on."

10 You say:

11 "... the size of the alleged Overcharge needs to be
12 considered in the correct context -- ie, in light of the
13 processes ..."

14 Now, I do not think there is any disagreement with
15 that at a high level of abstraction, but what I am
16 putting to you here is, given how tiny this element of
17 the cost base was, the various processes you rely on do
18 not justify the conclusion that the prices were actually
19 set higher because of this tiny overcharge.

20 A. Well, I worked through the implications of the
21 processes, to the extent that I have information on them
22 at different points in time and different parts of
23 business, to understand or assess as best I can the
24 implication of a set of costs without the overcharge, to
25 understand the potential implications for prices.

1 Changes -- it changes, which is why I have done it in
2 the way that I have done it. That is why I said there
3 is no inherent relationship, you have to apply it as
4 best you can in the circumstances of the pricing regime
5 or the regulatory regime at a given moment, to see what
6 implication those different set of costs have for prices
7 overall.

8 Q. Let us talk about non-cost factors for a minute. I am
9 now talking about non-regulated prices. You are aware,
10 I am sure, that the evidence shows Royal Mail and BT
11 took into account a range of factors other than cost.
12 So cost was a factor in setting prices, but certainly
13 not the only one. Would you agree?

14 A. I would agree.

15 Q. If your analysis were to be right, there would have to
16 be a highly mechanistic link, would there not, between
17 costs and prices if these tiny, tiny droplets of money,
18 these costs, were going to show up as a tiny increment
19 on the prices. Would you agree?

20 A. I am not sure I would agree it has to be mechanistic.
21 It depends upon the outcome of a process. The process
22 does not have to have a mechanistic construct if it
23 arrives at an outcome where prices change.

24 Q. But you still need to have a form of pricing that says,
25 here is this 0.003% cost uptick, say, and as a result,

1 we are going to have a 0.003% price increase. That is
2 the logic of your argument, is it not?

3 A. The logic of my argument is, to the extent you have
4 a different set of costs, slightly higher, slightly
5 lower, depending on which way you are looking at it,
6 what does it mean for the overall level of revenues that
7 you are allowed to make in a regulatory framework or you
8 wish to make in a commercial framework in order to make
9 a profit as part of your commercial objectives. So your
10 overall prices will change depending on which of the
11 avenues you are looking at, or may well change. It does
12 not mean all of your products have to change in price.
13 It means that you are seeking to increase your revenues
14 if your costs are higher, and you do not need to or you
15 are not allowed to if your costs are lower.

16 Q. But you have to proceed on the basis here that you have
17 this little bit of money, this droplet of costs, as I am
18 going to call it, if you will allow me, then you have
19 a kind of commercial judgment, what will the market
20 bear, what are the competition asking for, or if you are
21 in a bidding process, negotiating with a bidder, you
22 then end up with a sort of commercially viable price
23 point, whether it is a stamp price to the penny or
24 a unit cost or something of the kind, but on your
25 analysis, what is needed is that droplet of cost turns

- 1 into a droplet of price, does it not?
- 2 A. You are not looking at what you keep calling the droplet
3 of cost, you are looking at a different body of costs.
4 Okay? They are slightly different, but it is very
5 important. You are not wondering about the increment,
6 you are considering what to do with a different body of
7 costs, which is slightly different. Again, it is
8 important, because you come to apply your processes in
9 the same way. You are not thinking about the droplet,
10 you are thinking about your costs, to use your
11 language --
- 12 Q. But you --
- 13 A. Let me just finish.
- 14 Q. Sorry, please.
- 15 A. So you go through the processes in the normal way about
16 how to measure your costs, how to allocate your costs,
17 how to think about the implications for pricing or
18 regulatory recoveries, whatever it is, and you arrive at
19 your desired outcome and your plans in respect of
20 prices. Now, there may be other factors that intervene,
21 at that point, I agree with you, but that does not mean
22 you do not go through the process in the same way, and
23 if you were trying to recover a series of costs, that
24 you want a series of revenues to recover them and you
25 have a slightly different series of costs, then you

1 would have a slightly different series of revenues to
2 recover them. That is the process you would go through.

3 Q. Then the critical step though, is what you are calling
4 slightly different, it is a tiny, tiny difference, but
5 for that to be passed on, that tiny difference has to be
6 reflected in a tiny difference in cost.

7 We are not concerned in this case about the totality
8 of costs, about copper pipes or any of those other
9 things, we are interested only in this tiny droplet. On
10 your analysis, that shows up in a tiny uptick in costs,
11 does it not?

12 A. Do you mean prices?

13 Q. Prices. I did, thank you.

14 A. Okay. That is all right. Yes, the consequence of the
15 costs being higher, to the extent it flows through, is
16 that prices are higher. The consequences of costs being
17 lower is that prices are lower, again, depending upon
18 which part of the system you are looking at so -- but
19 the point is you are not isolating in the counterfactual
20 this increment and then saying, what shall I do with it?
21 You are just starting with a different set of costs.
22 That is how you identify the difference between the two
23 positions.

24 Q. The critical point though is, even if one looks at the
25 totality, the totality might be £1.6 billion, as in fact

1 we will look at, tomorrow, an example where that is the
2 case, you have got a tiny amount of overcharge which is
3 somehow buried in that 1.6 billion of cost, and on your
4 analysis, the price, fixed on the basis of that
5 1.6 billion, has to actually be higher as a result, even
6 if the overcharge might be just a few tens of thousands?

7 A. It would depend upon the level of the overcharge and how
8 the processing goes through, but you play the process
9 through.

10 Q. What I am suggesting to you is, it is unreal to suggest
11 that the actual price setting, based on these tiny
12 increments, could actually be changed as a result of the
13 overcharge?

14 A. But that is happening all the time to the extent you
15 have a different set of costs. It is happening all the
16 time, to the extent you have a different set of costs
17 and you are trying to think about the implications for
18 your prices. The overcharge is part of truck costs,
19 truck costs are part of costs. So to the extent your
20 costs change, for whatever reason or to whatever extent,
21 when you come back to revisit the question of what
22 am I going to ask for from the regulator, what
23 am I going to ask for from my customers, you have a body
24 of costs.

25 Q. Well, you are making it very clear that the logic --

1 that your position is, there will be a mechanistic
2 journey from that tiny bit of cost through to an actual
3 change in prices, even though it is so small as to be
4 almost undetectable.

5 A. No, there is a process that will be followed. The
6 outcome of the process will depend upon which piece of
7 the process you are looking at. I do not think of that
8 as a mechanistic process. I think of that as following
9 the processes that were established.

10 Q. There is no room on that for the sort of broad judgment
11 that settles at what you might call a viable or
12 commercially attractive price point, not driven by these
13 kind of small increments in cost?

14 A. So there will be moments and there will be products
15 where the pricing decisions do not respond to changes in
16 costs, I agree with you.

17 Q. What I am suggesting is that, even though costs are
18 taken into account in pricing, it is not with that level
19 of granularity in terms of price outcomes that your
20 analysis requires?

21 A. Sorry, say that again slowly.

22 Q. The costs are taken into account, but the price setting
23 is not so granular that the kind of cost increments you
24 are talking about are actually taken into account -- or
25 make a difference -- sorry, they are taken into account,

1 but they do not make a difference to the final prices?

2 A. Well, again, I think it matters upon which piece we are
3 talking about. In the regulatory regime, it matters
4 quite considerably because they are driven off of
5 assumptions about costs and revenues that you might be
6 allowed to recover those costs. In other areas, I think
7 there are, as I have said, some commercial underlying
8 incentives, though, as I have also said, I recognise
9 there are some uncertainties in those pieces of the
10 business.

11 Q. Let us talk about regulation in general --

12 THE CHAIRMAN: Shall we have a break now? Is that
13 a convenient time?

14 MR WARD: Of course.

15 THE CHAIRMAN: All right. We will have a ten-minute break
16 then.

17 As you probably know, whilst you are giving
18 evidence, you cannot talk to anyone about the case.

19 A. Of course.

20 THE CHAIRMAN: Thank you.

21 MR WARD: Sir, can I just ask how late the tribunal is able
22 to sit today? Obviously, we started early.

23 THE CHAIRMAN: Yes.

24 MR WARD: But I am --

25 THE CHAIRMAN: Well, we were thinking we could go on to

1 4.45.

2 MR WARD: That would be very helpful. Thank you.

3 THE CHAIRMAN: All right, we will do that.

4 Ten minutes.

5 (3.21 pm)

6 (A short break)

7 (3.38 pm)

8 THE CHAIRMAN: I understand the problems have been fixed
9 with the real-time, so good. Yes.

10 MR WARD: Thank you, yes.

11 Mr Bezant, could you go to tab 2.1 in your bundle,
12 which is {E/19/73}, please. This is talking about the
13 so-called government period, which is 1996 to 2001 for
14 Royal Mail, when prices were not regulated. I want to
15 look at the conclusions you drew as to why you concluded
16 there was, I think, 75% pass-on. If I can pick it up,
17 please, at 8.22, you say -- do you have that, Mr Bezant?

18 A. I do, thank you.

19 Q. Good, marvellous.

20 "The evidence I have seen supports a link between
21 RMG's costs (including Truck costs) and its prices ...
22 I have seen no evidence to suggest, and have no reason
23 to believe, that there was no link between costs ... and
24 prices. As a result, I consider that there was likely
25 a link between ... costs (including Truck costs) and its

1 prices, such that [they] were cost-reflective."

2 Then you quote two policy papers, one that requires
3 costs set geared to -- prices set geared to costs, and
4 another one that aims at the basic philosophy of more
5 closely aligning prices with costs. But would you
6 accept that is far less specific than you need if you
7 are going to conclude that these kind of scale of cost
8 increases actually changed the prices? This is just
9 broad alignment between costs and prices, is it not?

10 A. The information in paragraph 8.22 is dealing with prices
11 geared to costs and prices being aligned to costs, so to
12 the extent I am dealing with a type of cost, truck
13 costs, as part of total costs, then I am taking that
14 general framework as applying to truck costs and an
15 overcharge within truck costs.

16 Q. You are concluding on the basis of these general
17 statements, as well as some other things we will come
18 to, that those prices would be higher because of the
19 trucks?

20 A. As part of costs -- yes, the trucks are part of costs
21 generally, if truck costs are different, in the same way
22 as if any costs are different, then your costs are
23 different, and to an extent you are trying to align --
24 sorry, things keep falling over -- align your prices to
25 costs or make sure your prices are geared to costs or

1 cost-reflective, then it applies to truck costs as it
2 applies to all costs.

3 Q. What I am putting to you is it just does not follow at
4 all that such a small cost increment would actually
5 cause prices to be different on this kind of
6 consideration?

7 A. Well, to the extent that this is talking about costs
8 generally, and therefore any level of costs generally
9 and changes in costs generally, the objective of
10 aligning prices to costs, whatever they are, persists.
11 So, at a general level, I am looking at the framework,
12 the regulatory frameworks and so on, requiring or
13 desiring that your prices and costs are aligned. It is
14 not singling out truck costs because it does not need
15 to; they are just part of your costs.

16 Q. Aligned, but not necessarily with the precision required
17 that the costs actually are higher because of the
18 overcharge?

19 A. So I agree, there is uncertainty at the level of --
20 there is uncertainty, I agree with you.

21 Q. Okay.

22 If we turn over the page {E/19/74}, factor (3) is
23 there is a ABC costing system to provide costing
24 information to set prices that were cost-reflective;
25 a wide range of products so they had flexibility; and

1 that they took care in setting prices relative to costs.
2 Again, none of that gives us the answer, does it, that
3 prices were actually higher because of the overcharge?

4 A. Well, we do not have information from this period so
5 I am working with what I have as regards, as I have
6 said, the processes and the objectives and the
7 incentives within that period vis-a-vis costing and
8 pricing.

9 Q. Then, what you conclude, if we go to 8.26 on page
10 {E/19/76}, you say:

11 "... the best estimate of Supply Pass-on ... that
12 I am able to provide is based on the broad relationship
13 over this period between ... changes in ... costs (which
14 includes Truck costs); and ... changes in ... revenues
15 [which is] ... a proxy for prices. This ratio provides
16 a proxy for calculating the portion of changes in unit
17 costs that are recovered by changes in prices."

18 Then you extract the ratio 77.6%, and from that you
19 conclude pass-on is 75.

20 But again, what I put to you though is this is
21 a totally unjustified inference given how small the
22 truck costs are in the scale of these things. You are
23 looking here at total costs of around 5 or 6 billion and
24 obtaining a broad ratio. You cannot conclude from that
25 the prices were higher because of the tiny bit of truck

1 overcharge.

2 A. So what I have said here is, given the information we
3 have and given that truck costs are part of the total
4 costs, total costs are being treated equivalently, that
5 is aggregated cost, truck costs, are part of it, to the
6 extent there have been differences in costs, there would
7 be an expectation of differences in prices, but there is
8 very limited information with which to work.

9 Q. Let us move on to the Postcomm period, which began in
10 2001, and as Mr Beard said earlier, the first Postcomm
11 period, PC1, was just a price freeze in either nominal
12 or real terms. You and Mr Harvey essentially disagree,
13 but agree that the consequence that the treatment of
14 this follows from the treatment of the government
15 period. So I am not going to take time, unless you --

16 A. No, I am just absorbing what you said, it was quite
17 a long sentence.

18 Q. Sorry.

19 A. Okay. I think you said whatever we conclude for PC3 --

20 Q. No.

21 A. -- goes into Ofcom?

22 Q. No, the government period --

23 A. The government period? I am sorry. Excuse me. Sorry,
24 I thought you said Ofcom.

25 Q. Did I? I might have. I am sorry.

- 1 THE CHAIRMAN: Postcomm period.
- 2 MR WARD: Postcomm.
- 3 A. I am sorry, I misheard you. Forgive me. Yes, so
4 whatever we conclude for the government period, we
5 mirror in the PC1 period.
- 6 MR WARD: Yes, okay. Well, then I have put to you that we
7 do not accept there is any pass-on in the --
- 8 A. I understand.
- 9 Q. Let us talk now about PC2 and PC3, where things get
10 a bit more complicated, and there is indeed what we
11 might call formal regulation of a more sophisticated
12 kind.
- 13 Just in general terms, when a regulator sets prices,
14 it is engaged in a forward-looking exercise, is it not?
- 15 A. Yes.
- 16 Q. So it usually sets prices for a future period of some
17 years?
- 18 A. Yes.
- 19 Q. It does that by starting by looking at historical costs
20 and volumes?
- 21 A. Classically, yes.
- 22 Q. At that stage, it often applies its judgment as to what
23 level of cost to allow or how to apportion in between
24 products; would you agree?
- 25 A. Yes.

- 1 Q. When it does that, it has to make a whole range of
2 assumptions and judgments about the future, does it not?
- 3 A. Yes, it does.
- 4 Q. About the future level of costs and volumes, and many
5 other things as well?
- 6 A. Yes.
- 7 Q. When it does this, it is usually acting in pursuit of
8 statutory duties that have both a public interest
9 element and, of course, a need to have regard to third
10 party interests, such as competitors or downstream
11 rivals?
- 12 A. Yes.
- 13 Q. Then, in the end, it often incentivises efficiency by
14 setting charge controls that essentially challenge the
15 regulated entity to make efficiencies?
- 16 A. Yes.
- 17 Q. So would you accept then that the setting of a price
18 control of this kind involves a very large element of
19 regulatory judgment?
- 20 A. It involves a large number of decisions, some of which
21 involve judgments.
- 22 Q. The cost modelling that you have focused on in
23 particular is just one element in that much wider
24 process, is it not?
- 25 A. No, I do not think so. I am considering the process by

1 which PC2 was conducted and how that process would have
2 been conducted with a different set of costs. So the
3 framework of that control and the setting of it ex ante
4 is my template for asking what would have happened with
5 a different set of costs.

6 Q. Well, let us look at it now. I think the easiest way to
7 see roughly what was contained in PC2 is actually the
8 joint expert statement, because Postcomm's documents are
9 a little bit elusive. We can see that, it is tab 7 in
10 your bundle, or {E/83/38}. It is just at the bottom of
11 the page, although we will have to go over to the next
12 page, F.4.1, the experts are agreed:

13 "Postcomm set the level of the price control at
14 tariff basket level at a:

15 "P0 of 3.0% (which refers to the initial average
16 price increase in the first year of the price control);
17 and ..."

18 Over the page {E/83/39}:

19 "... [an] X [factor] of 1.0% [in other words RPI X
20 minus 1] (which refers to the annual adjustment to RPI
21 in each year of the price control)."

22 Yes?

23 A. Yes.

24 Q. The amount of overcharge you allocate in this period is
25 8 million and Mr Harvey says it is 5.6, but you do not

- 1 agree with him on that?
- 2 A. I do not -- if we differ if it is in our reports. The
3 precise numbers I do not recall. I remember my 8.
- 4 Q. Whichever sum we are talking about here, it is against
5 allowed revenues of about £17 billion, is it not?
- 6 A. Yes, there is a precise number for the allowed revenues.
- 7 Q. There is a precise number, we are going to come to that,
8 do not worry, but there is a very, very, very large
9 allowed revenue, of which the overcharge represents
10 a very tiny increment, does it not?
- 11 A. The overcharge being the difference between the actual
12 set of costs and the counterfactual set of costs is
13 small, but you would have had a large counterfactual set
14 of costs being put into the system.
- 15 Q. Now, I just want to talk about baskets for a moment.
16 The charge control was in the form of a tariff basket.
17 We can see that, if you would go to tab 20 of your file,
18 and if we could please go to {I3/374/20}.
- 19 A. Sorry, could you pause after you have given me the tab,
20 because by the time I have turned away --
- 21 Q. Of course.
- 22 A. -- to find the paper I have not heard your page
23 reference. Apologies. So, tab 20?
- 24 Q. Tab 20 and it is page 21.
- 25 A. Thank you. I have got it, thank you.

1 Q. Just for the tribunal, if this is going to help,
2 Postcomm often calls what is in effect its decision
3 "Final proposals document" -- for some reason it still
4 calls them proposals -- but that is what this is.

5 If we turn to page 21, thank you, and just scroll
6 down a little {I3/374/21}, we can see the structure of
7 the control is a tariff basket:

8 "This requires Royal Mail to set prices so that its
9 revenues do not exceed allowed revenues, in turn,
10 generated by the application of a pre-determined set of
11 maximum prices to outturn volumes."

12 Then there is something they call "Rebalancing
13 thresholds":

14 "Within the overall structure ... Royal Mail will be
15 allowed to raise prices on any individual product in any
16 one year by up to 2.5% more than the allowed annual
17 price change, with exceptions [for certain
18 products] ..."

19 In fact, just to pause there but to just leap ahead
20 temporarily to PC3, there are also baskets in PC3 as
21 well and rebalancing thresholds, you will recall.

22 A. Yes.

23 Q. They are slightly different. There are two baskets, but
24 the same thing essentially applies.

25 Would you accept that, for the regulated entity,

1 actually seeking to maximise the revenue in these
2 baskets would actually be quite challenging, because you
3 would be trying to predict the volume of products and
4 the mix and the demand, and comply with the rebalancing
5 thresholds going forward for a number of years?

6 A. Well, there are constraints as a consequence of the
7 rebalancing thresholds. They did set out to price very
8 close to the cap, so that must have meant that they
9 expected to be able to do it. Ex post may have been
10 different, but ex ante the ability to think about the
11 configuration of products in order that at the prices
12 they could hit, pretty much hit the cap, was an
13 expectation.

14 Q. Expectation, but would you accept it would actually be
15 rather difficult to get this exactly right?

16 A. You mean ex post?

17 Q. Yes. Well, you are setting your prices, you are going
18 into the price control. It is going to be quite hard to
19 be absolutely precise in order to collect exactly the
20 revenue that Postcomm is allowing you.

21 A. Well, it depends upon what happens subsequently and
22 whether, within the regulatory framework, you can
23 respond sufficiently to price up to the cap or achieve
24 revenues up to the cap. I mean, there is a whole
25 bundle of products, so there is a lot of, at one level,

1 degrees of freedom to work with. The question of how
2 far or how close you get to it is an ex post question.

3 Q. We will talk about that with PC3. But let us stick with
4 PC2 for the minute, which is 2003 to 2006. I want to
5 show you document {I3/375} which for you is tab 19. Can
6 we go, please, to page 53 {I3/375/53}? This is
7 Postcomm's proposal document, which is essentially
8 a consultation paper. It explains what the driver was
9 from Royal Mail's point of view for PC2.

10 Can we pick it up, please, at paragraph 6.4, at the
11 bottom of the page:

12 "Consignia [which was then Royal Mail's name] has
13 recently asked Postcomm to set the level of the revised
14 price control on the basis of it being allowed to raise
15 regulated revenue by about £170m (equivalent to 1p on
16 First and Second Class products) no later than
17 1 April 2003 with prices remaining on the whole at that
18 level for the following three years. Consignia argues
19 that this is necessary to ensure that it can finance its
20 licensed activities and implement its renewal programme.

21 "Consignia's rationale is based on it needing to be
22 able to demonstrate a commercial case for borrowing
23 resources to pay for the up-front costs necessary for
24 restructuring ..."

25 Then, at 6.6 {I3/375/54}, we can see:

1 "The DTI has also submitted its shareholder
2 perspective to Postcomm. It supports Consignia's
3 request on the level of the revised control."

4 So what was being asked for here was a rather broad
5 brush funding of a penny on first class products,
6 roughly 170 million, was it not?

7 A. Well, it says it wants to raise regulated revenues by
8 a certain sum of money, which is described as
9 "equivalent to". Whether that was the proposed
10 solution, I am not -- I do not recall from this
11 document, but it is describing it as equivalent to.
12 Other things obviously may have achieved the same
13 overall number, but this is described as being
14 equivalent to doing that to two key products.

15 Q. What they are asking for is about 170 million, as you
16 see.

17 Can we now go to the Postcomm final proposals, which
18 is tab 20 for you and it is {I3/374}, please, for Opus.
19 Could we go, please, to page 70 {I3/374/70}? Just
20 scroll down a little. 7.44:

21 "In setting the level of the control, Postcomm has
22 set the allowed revenues so that on Postcomm's central
23 view of volumes, operating, capital and renewals
24 expenditure, Royal Mail will be broadly cash
25 neutral ..."

1 Of course, the word "central" there obviously
2 implies there were a range of views on this.

3 "As noted above, having established revised cash
4 projections for the business, Postcomm must assess the
5 level of required revenues ... to [achieve] the
6 alternative options ... In Postcomm's October 2002
7 proposals, the initial increases in average prices were
8 intended to increase average revenues by about £170m in
9 the first year."

10 In other words, what it was Royal Mail was asking
11 for.

12 "This was equivalent to a nominal increase of 3% in
13 revenues from 2002/03, and equivalent to 1p/1p on the
14 first weight step of first and second class public
15 tariffs and associated products. Subsequent price
16 adjustments were to be subject to a limit of
17 RPI-2.5 ..."

18 So that was the proposal, to do what Royal Mail
19 wanted but to apply an RPI X factor of 2.5; yes, so far?

20 A. That is what 7.45 says.

21 Q. Good.

22 Then, at 7.46 {I3/374/71}, Postcomm notes that in
23 fact Royal Mail says it now needs more cash, 584 million
24 and it says that does not warrant an increase in the
25 revenue requirement.

1 "The revised structure of the price control in
2 itself will allow Royal Mail to recover higher revenues
3 if its product mix changes in the way [it] anticipates."

4 So it will get more money if your forecast of how
5 products change materialises, and, at the second bullet
6 point:

7 "[It] now expects the business volumes to be
8 higher ...

9 "In effect, therefore, only a remaining £240m ...
10 needs to be recovered ..."

11 Then it considers various options, but over the
12 page, we can turn now, please, to the next page, 7.49
13 {I3.374.72}:

14 "In developing its final proposals, Postcomm has
15 considered customers' desire to see a reasonably smooth
16 profile of prices over time ..."

17 Then, at 7.50:

18 "Against this background, Postcomm is of the view
19 that retaining the initial price increase of 3% and
20 relaxing the X factor from the initial proposals of 2.5%
21 to 1.0% would best achieve the discharge of its duties
22 in setting Royal Mail's second price control."

23 7.51:

24 "It should be noted that the proposed X Factor does
25 not in itself represent the full extent of the

1 efficiency improvements that Postcomm is assuming
2 Royal Mail will make. In accepting the WSA [which is
3 Atkins] operating and capital expenditure projections,
4 Postcomm has assumed that in addition to the efficiency
5 improvements that Royal Mail is planning to make, [it]
6 ought to be able to make efficiencies of the order of
7 £500m ... in operating and capital expenditure over the
8 three years ... This would amount to efficiency gains of
9 approximately 6% over the three years ..."

10 Well, what we see, Mr Bezant, if we step back, is
11 Royal Mail asked for about 170 million and Postcomm
12 delivered it, did it not?

13 A. Well, Royal Mail asked for a particular increase in
14 revenues back in the original proposals. By the time
15 you get to the final proposals, quite a few things had
16 changed in expectations, and Postcomm had considered,
17 based on the costs associated with these revised
18 assumptions about the level of volumes and so on, how to
19 set the regime so as to match costs and revenues.

20 Q. Or to, as it put it, make sure it was broadly cash
21 neutral. But the key point here though is a broad
22 request was made for revenue; Postcomm has delivered on
23 it. It has also used its judgment, really at the last
24 minute, to relax the X factor from minus 2.5 to 1.0.
25 What I am suggesting to you, Mr Bezant, is this is broad

1 regulatory judgment, admittedly laid over detailed cost
2 analysis, but this ultimately is what drove the
3 decision. It is a matter of regulatory judgment.

4 A. So there is regulatory judgment at the very end of the
5 process, I agree with you. The question is, had there
6 been a different set of costs, what would that have
7 meant in the first instance for the required revenues in
8 order to achieve cash neutrality and what would that
9 have meant for the overall regulatory conclusion?

10 Q. I am suggesting to you that in the 17 billion of allowed
11 revenue that there is, the idea that 8 million of
12 overcharge, on your figures, might have made
13 a difference to this increase of 3% and this X factor of
14 1 is unreal.

15 A. I do not agree with that, as you know, because they were
16 operating to fine margins when thinking about the
17 consequences of different ways of modelling this so as
18 to match costs and revenues, and so --

19 Q. Well --

20 A. Sorry, excuse me. So had they had a different set of
21 costs, how they would have modelled the revenues is the
22 question they would have faced. They are not comparing
23 it to this, they would have been looking at something
24 ab initio.

25 Q. They would have been looking at something that was

1 8 million different against 17 billion allowed revenue,
2 would they not? That is the difference.

3 A. They would be looking at a different set of numbers.

4 They would not be comparing the two. They would just
5 have a different set of numbers --

6 THE CHAIRMAN: Mr Bezant, you have often referred to this
7 different set of costs that they are looking -- you are
8 talking about the counterfactual?

9 A. Well, I am, because --

10 THE CHAIRMAN: Well, the only difference, surely, is the
11 lack of the overcharge?

12 A. But in the counterfactual one does not know about the
13 actual, one is just dealing with a different set of
14 costs, and therefore the decisions one is making are by
15 reference to that different set of costs. The process
16 is one of deploying by reference to that different set
17 of costs. So it may be that --

18 THE CHAIRMAN: What is different apart from the overcharge?

19 A. In monetary terms, nothing. But in terms of the process
20 that you are deploying, you are not saying to yourself,
21 "I have only got 8 million to allocate or reallocate"
22 because you do not think of it like that. You think of
23 it as "I have got a large body of costs that I need to
24 think about the regulatory regime for, I need to think
25 about how much the costs are and how much the revenues

1 need to be to match that". You are not thinking about
2 the 8 because it does not eventuate. You are just
3 thinking about a different set of costs that happens to
4 be 8 million different to the actual world. But you do
5 not have the actual world to compare and contrast
6 against; you just have the counterfactual world.

7 MR WARD: Mr Bezant, let me try again, because it is perhaps
8 simpler than that makes it sound. It is just going to
9 be 8 million less in the cost stack. What I am
10 suggesting to you is, it is completely implausible that
11 this broad measure of 3% increase and RPI minus 1, could
12 possibly be different because of 8 million?

13 A. No, I am not sure I agree with that, because the way in
14 which they were calibrating to get to the level of costs
15 they were dealing with was a close calibration, the kind
16 of headroom they were thinking about and allowing. That
17 is not a large number, that is a small number, because
18 they are trying to calibrate to the particular set of
19 costs in mind. So the question is --

20 Q. Let --

21 A. I am sorry -- the question is would they have calibrated
22 differently if they had 8 million less -- fewer costs,
23 excuse me.

24 Q. The ultimate question is: would the charge control have
25 been different? I am suggesting to you the answer is

1 very obviously and inescapably it would have been the
2 same.

3 A. And I do not think that follows.

4 Q. Let us look at your headroom point which is developed in
5 detail in your reports. We can see on page 72 here,
6 there is a table {I3/374/72}.

7 A. Sorry ...

8 Q. Page 72? There we are. Table 7.14.

9 A. Oh, right.

10 Q. This is where Postcomm is considering three different
11 options. Option 2 is the one it actually went for,
12 which is giving Royal Mail what it wanted, P0 increase
13 of 3%. Your headroom, as I understand it, is this
14 figure of 21 at the end, which is to say there is
15 a cashflow of a 21 positive. What you have argued in
16 summary in your report is that that headroom might have
17 been different without the overcharge?

18 A. Yes.

19 Q. Because you say that the -- I think, if I am right -- if
20 the amount granted was 0.1% less, then that headroom
21 would have been down to 4, I think is how you put it, is
22 it not?

23 A. Yes, a 0.1% difference in X removes about 17 million off
24 that.

25 Q. You say that shows it is highly significant that they

1 deliberately allowed this headroom?

2 A. Well, they allowed some headroom.

3 Q. What I am suggesting to you is that that so-called
4 headroom is just a small positive number that is derived
5 from the option, which is 3% plus X minus 1, and the
6 decision was to grant that option, and then the headroom
7 is just a function of the arithmetic. It is not
8 deliberate at all.

9 A. Well, no, they are trying to -- when you look at
10 option 1, they are trying to see how close they can get.
11 When you look at options 2 and 3, they are thinking
12 about different patterns and the implications of the
13 different patterns for how close you get. So they are
14 thinking about the combination of P and X to match
15 revenues and costs in cashflow terms.

16 Q. Well, I have put my case to you on this I think
17 sufficiently. Let us move on to Postcomm period 3.

18 This is, as we heard earlier, a RAB-based control.
19 You have concluded here that Royal Mail has achieved
20 a pass-through of up to 140%?

21 A. Depending upon the treatment of the truck costs within
22 that regulatory regime, yes.

23 Q. Yes.

24 You will be aware that Mr Harvey, even though he
25 disagrees with a lot of things in your analysis, he

1 thinks that even if you are right, the correct figure is
2 126%, because you have assumed trucks purchased in
3 2005/6 under operating leases would be included in the
4 RAB, despite the fact the leases are operating leases.
5 Do you accept he is right about that?

6 A. I have assumed that Postcomm assumed what they said they
7 were going to assume, yes.

8 Q. Okay.

9 Now, let us talk about --

10 A. That is why the difference emerges between us. He
11 assumes, I think, that they did not do what they said
12 they were going to do. Or maybe he is assuming that
13 they did not do what they said they were going to do.
14 I am assuming they did.

15 Q. I see, okay.

16 Let us look at what Postcomm actually did in this
17 control, please, because this is another RPI minus X
18 control, and again, there were two baskets -- this time
19 there were two baskets of products. Let us go to
20 tab 21, please, in your bundle, and {I3/392}. These are
21 the licence modifications proposals that come at the
22 end, which, again, are effectively a form of final
23 determination by Postcomm.

24 Could we turn to page 5 {I3/392/5}? Just scroll
25 down a little bit, please, to S.9. There we are. Do

1 you have that, Mr Bezant?

2 A. I do, thank you.

3 Q. Lovely.

4 "The price caps set out in the Final Proposals
5 contained an initial increase in the average revenue
6 that Royal Mail can earn ... in 2006/7 of 6.2% in
7 nominal terms followed by an annual reduction in each
8 subsequent year of RPI-1.5% ... and RPI-3.5% ... Within
9 this average, Royal Mail had the flexibility to increase
10 individual prices by ... 3% [and that is the rebalancing
11 threshold] ... Postcomm stated that it welcomed views on
12 ... a different pricing profile, provided that the net
13 effect was expected to be revenue neutral ..."

14 Then, over the page {I3/392/6}, where it ended up,
15 under S.11, is table 1, captive tariff basket, 4%,
16 RPI-0.14%; non-captive tariff basket, 4%, RPI-1.96.
17 What you have said -- then, sorry, S.12, rebalancing
18 thresholds of 3% again.

19 What you have said in your joint expert statement is
20 that this two decimal places demonstrates a high degree
21 of precision, high enough that the overcharge increment
22 of .600,000 might actually be picked up or reflected?

23 A. The change of 0.01% is about a 600,000 change. The
24 overcharge in the period is about 1.7 million per annum,
25 so the overcharge exceeds the 0.01% increment by some

1 distance.

2 Q. Let us look at how we actually got there though. Can we
3 now turn to tab 22 for you and {I3/113} for us, please.

4 These are the final proposals, albeit again for
5 consultation, which was the consultation element we are
6 going to see in a minute -- sorry, we have already seen.
7 Can we turn to page 182, please -- I am sorry, this
8 reference is clearly wrong or I am in the wrong ... so
9 sorry, just please give me a moment and I will find the
10 right reference. No, it is right, there we are.
11 {I3/113/182}.

12 If we look at paragraph 9.98, at this point Postcomm
13 is saying:

14 "As a result of Postcomm's decision on the different
15 aspects of the price control, the overall average price
16 control for all price controlled products will be
17 equivalent to RPI-0.1% ... compared to RPI-2.5% in the
18 Initial Proposals. The Initial Proposals were for
19 average price controls of RPI-3% for the 'captive'
20 basket and RPI-2% for the 'non-captive' ..."

21 9.99:

22 "The average price controls for each tariff basket
23 cannot be compared directly to the Initial Proposals
24 because of the inclusion of [a] second class public
25 tariff ... [in the basket]. The average annual ...

1 controls for the Final Proposals ... will be ... +0.5%
2 ... or -0.6%".

3 So that was where Postcomm was at this stage, so it
4 was just to one decimal place, you see, the RPI factor.

5 Then, if we look at the next page, at 9.102
6 {I3/113/183}:

7 "Royal Mail has argued that average price controls
8 should be sculpted to provide it with a large increase
9 in prices in the first year ... [It] is keen to do this
10 to cover its expected pension costs ... In principle,
11 Postcomm does not object to that sculpting provided ...
12 overall, the price caps are ... [revenue] neutral.

13 Then, turning the page now again to 149
14 {I3/113/184}, at 9.108, it says:

15 "Postcomm is proposing that for the 'captive' basket
16 the first year price change is an increase of 6.2% in
17 nominal terms followed by RPI-1.5% ... For the
18 'non-captive' ... 6.2% in nominal ... followed by
19 RPI-3.5% ..."

20 Then, if we now go back to its final decision,
21 please, which was your tab 21, to page 5, which is
22 {I3/392/5} -- thank you, just down a little bit more --
23 at S.9, do you have that, Mr Bezant?

24 A. I do, thank you.

25 Q. S.9, it explains again what its final proposals were.

1 In the last few lines it says:

2 "... it welcomed views on whether it ought to adopt
3 a different pricing [proposal], provided that the net
4 effect was expected to be revenue neutral in present
5 value terms to Royal Mail ..."

6 Then many organisations made representations about
7 that, saying they wanted the price cap to be phased in
8 a way that smoothed the profile over the period. Over
9 the page {I3/392/6}. Then S.11:

10 "Given that customers sought a lower ... price
11 increase, Postcomm has decided to limit overall average
12 revenue[s] ... to 4% ... this still enables Royal Mail
13 to raise prices more sharply in the ... subsequent
14 years, Postcomm believes this achieves a balance between
15 the views expressed by [judgment] and the need for
16 Royal Mail to cover cost increases ... including ...
17 pension ... contributions."

18 So that is how we end up with a round number of 4%,
19 which is a matter of regulatory judgment, and then an
20 almost peculiarly highly granular RPI X to two decimal
21 places. It has got nothing at all to do with a highly
22 refined judgment of RPI X, it is just a regulatory
23 judgment about the balance between a broad cost increase
24 upfront and then a rather reduced RPI X later.

25 A. No, I do not agree with that. In trying to balance off

1 various objectives, including things being NPV neutral,
2 in other words you cover the costs, you allow a profit,
3 but there is a certain, again, balancing off, within
4 that they were allowing a particular increase in the
5 first year, but they were still then ensuring that the
6 overall balance of costs and profits was very carefully
7 controlled in years 2 to 4 through applying RPI minus X
8 controls for the two different baskets to two decimal
9 places. If they had had a different combination of
10 costs that led you to needing to apply a slightly
11 different RPI in years 2 to 4, then that is what it
12 seems to me they could have done and would have done.
13 They have not rounded there. It is 0.14 and it is 1.96.
14 They are very precise. So if they had a different set
15 of costs, the precision would have applied to
16 a different set of costs and would have been,
17 essentially, accommodating another set of costs, and
18 hence a different X factor.

19 Q. The point I am making is that the two decimal place RPI
20 is really just arithmetic flowing from giving a broad
21 increase of 4%?

22 A. But it is within the overall objective of allowing the
23 recovery of costs and a margin of costs in NPV terms,
24 subject to then making some particular allowance for
25 year 1. But you have still got to get back and solve

1 the equation over years 2, 3 and 4. So if your costs
2 are different, the way you solve the equation in 2, 3, 4
3 are different, and you do it to a high degree of
4 precision. That is what this tells me.

5 Q. Now, the RAB in this instance was between around
6 2 billion and 2.6 billion, was it not, depending on
7 which year we were talking about?

8 A. Yes.

9 Q. What we are talking about here is truck overcharge of,
10 I think, 8 million across the whole period, are we not?

11 A. Yes.

12 Q. So the argument is that we can say with confidence that
13 this overcharge is in fact captured in this very large
14 RAB and would have made a difference to those figures.

15 A. The overcharge is in the RAB or in the operating costs,
16 depending on what one assumes. It does make
17 a difference at the level of granularity being
18 considered in the context of this price control
19 calculation. It does make a difference. We talked
20 about that. 0.01% adjustment is about 0.6 million per
21 annum. The overcharge is 1.5 million plus per annum so
22 it does make a difference.

23 Q. Can we look at the LECG modelling that was discussed
24 with Mr Harvey this morning, which is in {I3/391/143}.
25 For you, Mr Bezant, it is tab 23. It is page 143. Just

1 scroll down a little more, please. This is what went
2 into the forecast RAB. Can we see 9.52, please? Do you
3 have it now, Mr Bezant?

4 A. I do, thank you.

5 Q. Lovely.

6 "Royal Mail included in its revised Strategic Plan
7 an initiative relating to its vehicle procurement
8 policy. This initiative shows the effect of a shift to
9 purchasing rather than leasing vehicles, as current
10 vehicle leases expire. Royal Mail stated that it began
11 leasing vehicles in 1999 due to government cashflow
12 restrictions. However, purchasing vehicles outright has
13 recently become more financially attractive ...
14 Royal Mail stated that, although for the purposes of the
15 Strategic Plan it has assumed a full switch to buying
16 vehicles, it will in fact continue to review its
17 buy-vs-lease ... decision on a quarter-by-quarter
18 basis."

19 You can see there, would you not agree, there is
20 some uncertainty about actually what Royal Mail will be
21 doing in the future?

22 A. That is what it says in this document, although there is
23 a document clearly that explains the policy to move to
24 100% purchasing.

25 Q. Yes, but keeping it under review is what it is saying?

1 A. Yes.

2 Q. Then, at table 85, it includes these capex figures for
3 vehicle procurement and, of course, as we have already
4 discussed, trucks are only a small element of vehicles
5 and overcharge is of course only a small element of
6 trucks, even on my client's case, never mind your
7 clients where there is not one; yes?

8 A. Well, overcharge is about 10% of trucks as presented on
9 your client's case.

10 Q. Yes.

11 A. Trucks are a small proportion of vehicle costs.

12 Q. Yes. So it is a lot less, as far as we are concerned,
13 than the numbers we are looking at here in table 85,
14 which talks about essentially 108, 108, 108, and 160.
15 But it is something a lot less than that that we are
16 concerned with, is it not?

17 A. Yes.

18 Q. We saw this morning -- I am sure you were here, I think
19 I saw that you were -- that Postcomm challenged
20 Royal Mail -- sorry, LECG challenged Royal Mail as to
21 exactly why it was doing this and what the economic
22 justification for it was.

23 Then at 9.55, it says:

24 "Based on the data provided to us on historical
25 lease payments, and on new capital expenditure

1 requirements, we estimated the point at which the two
2 options were financially equivalent ... This implied
3 a reduction in Royal Mail's planned capital
4 expenditure."

5 Then we see, in the table below at 86, it comes up
6 with this number that, as Mr Harvey pointed out, seems
7 to be a round number every year of 95 for capex.

8 Now, Mr Beard put to Mr Harvey this morning that
9 this exercise by LECG was, as he put it, very accurate
10 and precise but it is right, is it not, that we do not
11 actually know how it got from 9.55 to 9.56, do we? It
12 has not provided its workings, unless you are about to
13 spring a spreadsheet on me.

14 A. No, I do not have anything other than you have. But we
15 know that they looked at the historical lease payments,
16 which are the actuals, and they were given some
17 information on capital expenditure requirements. What
18 they were doing here was trying to work out whether the
19 capital expenditure requirements were, I think,
20 overstated because there will be some trade-off
21 obviously between what you pay and what you would lease
22 for the same vehicles. They were testing the size of
23 the asserted capital expenditure, but that would likely
24 be a precise exercise because the lease payments are
25 a precise number.

1 Q. Really all I am putting to you is two things. One is we
2 do not know exactly how it got to this round number of
3 95, do we?

4 A. I do not know how they got to the numbers presented in
5 the table, no.

6 Q. When we think that that is capex for vehicles, and
7 trucks are a small part of vehicles and overcharge is
8 a small part of trucks, we cannot really be confident,
9 can we, how much overcharge is captured in that 95?

10 A. I do not know how the analysis was done here. I have
11 got no reason to believe it was not done precisely,
12 given the degree of precision that goes into the costing
13 exercise generally and to these processes. We have
14 figures presented to the nearest million so it seems to
15 me that -- and all of the forecasts you see tend to have
16 numbers presented to a million, rounded up, rounded
17 down. Therefore it seems to me that people would be
18 working in precise numbers rather than rounded numbers
19 if they are going to present the result of that to the
20 nearest million.

21 Q. Let us talk about the outturn of this charge control.
22 I am sure you are aware that in fact this was
23 essentially a failure from Royal Mail's point of view,
24 and Mr Harvey has explained Royal Mail's cashflow was
25 around £3 billion lower than Postcomm had actually

1 forecast. Are you aware of that?

2 A. Yes.

3 Q. Let us just quickly look, please, at Mr Jeavons' witness
4 statement which is {D/7/9}. In your bundle -- so sorry,
5 I am actually not sure it is in your bundle.

6 A. That is fine.

7 Q. Oh, it is tab 29 in your bundle as well if you would
8 like to turn it up. Can we scroll a little bit lower,
9 please, so we can see the whole paragraph? Thank you.
10 Tell me when you have that. Page 9. He says:

11 "As I explained above, Postcomm's regulation of RMGL
12 caused serious issues for RMGL and it is telling that
13 following the Hooper Report, Postcomm was abolished and
14 the responsibility for regulating RMGL was transferred
15 to Ofcom (which Hooper recommended [was] more
16 appropriate ...). The price controls Postcomm applied
17 to RMGL were modelled on price controls applied to
18 utility companies which are high asset value businesses
19 not faced with the challenge of industry decline and
20 which, unlike RMGL, provide unavoidable services. This
21 led to a fundamental mismatch between Postcomm's
22 assumptions and the realities RMGL was facing,
23 especially in the second half of the Postcomm Period.
24 In particular, Postcomm failed to predict (as did RMGL
25 to a lesser extent) the scale of volume that RMGL stood

1 to lose to Access operators and as a result of
2 e-substitution. Added to these challenges, the
3 strictures of the price control constrained RMGL in its
4 ability to react to these changing market conditions and
5 protect itself financially. The net result of all of
6 this was that by the end of the Postcomm Period, RMGL
7 was in serious financial difficulty. I recall that in
8 2010 when I was financial controller, each month I was
9 putting together a cash forecast as we had real concerns
10 about RMGL's financial viability ... It was around that
11 time that we instituted a programme of cash management
12 action, trying to generate cash, for example by the sale
13 and leaseback of mail centres ..."

14 Et cetera.

15 What I am putting to you here is that this level of
16 failure is just not consistent with the idea that this
17 super granular process, as you have been describing it,
18 really was in any way accurate at setting the charge
19 control at a level that would capture the overcharge or
20 any other costs.

- 21 A. So it was designed on an ex ante basis, obviously, to
22 set regulation with a particular objective, in this case
23 to recover costs and allow a profit on certain forms of
24 asset. So that is what it actually did.

25 In the counterfactual, with a different set of

1 costs, it would have actually approached the same
2 question in the same way and we have discussed whether
3 it got to a different or the same answer. What happened
4 next does not affect whether they would have behaved
5 differently in the counterfactual in setting a different
6 regime. It played out differently but that does not
7 mean that they would not have reacted to a different and
8 lower set of costs in the counterfactual.

9 Q. I am putting to you a slightly different point, which is
10 just that. There is such a wide variance between what
11 Postcomm predicted and reality that one just cannot say
12 with any confidence that the overcharge costs were
13 actually recovered through the prices.

14 A. Well, let us take this in stages. If the costs had been
15 different, question one, would prices have been
16 different? We have talked about that and I say I think
17 they would have been in PC3 at a lower level of costs.
18 So prices are set differently in the sense of allowed
19 revenues are set differently, so you have a lower set of
20 allowed revenues so your revenues are different.

21 There is a secondary question, when your business
22 does not proceed in the way that people had expected,
23 but that does not mean that you are not, again,
24 operating against a lower price ceiling and a lower
25 revenue ceiling. You are just finding it hard as well

1 but it is a different reference point. It is a lower
2 reference point so your revenues are different.

3 Q. The revenues are different but the point I am making is
4 a separate one, which is the fact that there was such
5 wholesale under-recovery really calls into question
6 whether these charges were recovered?

7 A. Well, again, it depends over which period of time you
8 ask yourself the overall recovery of overall costs.

9 Q. We saw earlier that you ran it all together over
10 a 12-year period but I am certainly suggesting that in
11 this period that would not be appropriate.

12 Now, I need to take this next point very quickly
13 just because of time. You are aware that there were
14 a whole series of further changes over the life of this
15 charge control, I am sure.

16 A. PC3?

17 Q. Yes.

18 A. Yes.

19 Q. So as early as 2007, right at the beginning, Royal Mail
20 was pleading with Postcomm to relax the balancing
21 thresholds because it was unable to change its prices to
22 keep up with the market, and they were changed, I think
23 twice, and it was extended twice as well. So by the end
24 of the period, the initial modelling was many years old,
25 yes?

- 1 A. Yes.
- 2 Q. So what I am putting to you again is that none of that
3 is consistent with a highly fine-tuned overcharge
4 control that could reflect the sums of overcharge that
5 we are considering?
- 6 A. I do not agree with that because, by reference to what
7 happens at the beginning and the price and revenue
8 thresholds and caps that are established, that then
9 carries through.
- 10 Q. Well, I have put my case to you.
- 11 Let us talk about Parcelforce very briefly.
12 Firstly, there is a disagreement between you and
13 Mr Harvey about the amount of overcharge involved here
14 as between -- the amount of overcharge attributable to
15 Parcelforce.
- 16 A. The allocation between Royal Mail and Parcelforce.
- 17 Q. Yes. It gets quite intricate but I am going to put
18 a high level point to you, again because of time. Your
19 approach is based on the relative revenues, as it were,
20 between Parcelforce and the rest of Royal Mail, is it
21 not?
- 22 A. Yes, over the period in question, yes.
- 23 Q. Mr Harvey's view is that that understates the position,
24 essentially because Parcelforce's use of trucks is
25 greater than the revenue share would imply?

- 1 A. Yes.
- 2 Q. You do not accept that?
- 3 A. No, I think I say that Parcelforce uses proportionately
4 more trucks, for want of a better phrase, so
5 I acknowledge that --
- 6 Q. But you do not accept that that shows that your
7 attribution is wrong?
- 8 A. Well, I acknowledge it but I am not sure I am confident
9 about his approach. There is a lot of it set out in the
10 report I think and it is no criticism of him. He is
11 pulling together different documents from different
12 moments in time to try to construct something. I think
13 that that has its limitations. There is not much
14 difference between our two calculations at the end of
15 the day, I do not think, but I prefer mine on balance.
- 16 Q. You will appreciate I put to you that Mr Harvey's
17 approach is to be preferred.
- 18 A. I understand. I said I prefer mine on balance.
- 19 Q. Let us talk a little bit about the substance and I am
20 going to try to take this quickly from the joint
21 experts' statement principally. Can we go to that,
22 which is tab 7 for you, and it is {E/83/64} for Opus.
- 23 A. Sorry, I have ended up a little behind. Tab 7?
- 24 Q. It is tab 7, page 64. K.3. As Mr Beard said earlier,
25 in the left-hand column:

1 "Parcelforce distinguishes between three customer
2 groups: consumers ... business customers; and
3 international customers."

4 You say that you understand bespoke rates with
5 business customers comprise the majority of
6 Parcelforce's sales.

7 A. Yes.

8 Q. We are going to look at those in a little bit more
9 detail in a minute. The first thing is at K.4, in terms
10 of retail rates -- I am so sorry, I now see we are going
11 to need the confidential version but let me just check
12 with my clients that they do not mind it going up on the
13 screen. (Pause)

14 It is okay if it goes on the screen and I am told
15 just not to read it out, if that is okay. Can we go to
16 {E/IC83/65}? I hope you have the confidential version,
17 Mr Bezant -- do you? -- highlighted in yellow rather
18 than redacted.

19 A. On my screen?

20 Q. No, in the hard copy.

21 A. I do, so the yellow is the confidential content?

22 Q. That is right. That is what we are going to try not to
23 read out.

24 A. Right.

25 Q. We see here, in relation to retail and contract,

1 Mr Harvey summarises the evidence as he sees it.

2 "... the witness evidence shows that:

3 "the tariff rates were not updated with reference to
4 changes in truck costs, or indeed Parcelforce's costs in
5 general;

6 "when the tariff rates were updated, they were
7 typically updated with reference to RPI ...

8 "I would not expect movements in truck costs to
9 affect the movements in RPI inflation and, if they did,
10 any effect would be de minimis; and.

11 "to the extent that Parcelforce considered its
12 costs, it did not involve 'any detailed consideration'
13 of the type that would be necessary to fine-tune
14 pricing ..."

15 What you say is you understand that:

16 "... the contribution margin (ie a margin above
17 cost) has been a key consideration in setting
18 Parcelforce's general consumer and business tariff
19 rates, which supports a relationship between costs and
20 prices. For example, in respect of general consumer
21 tariff rates, Mr Cahill states ..."

22 Then I will invite the tribunal to read the yellow
23 without me reading it out. (Pause)

24 What we see there, again without reading it out, is
25 that while contribution may be a factor, what Mr Cahill

1 is saying in this evidence is it is just one factor
2 among several, is he not?

3 A. Yes, he is.

4 Q. If we can just also look at Mr Cahill's witness
5 statement for a moment as well -- we are going to come
6 back to that -- but Mr Cahill's witness statement is
7 tab 26 for you, Mr Bezant, and for us it is {D/IC5}.
8 Again, I will not read it out but we will put it up on
9 the screen. It is page 14 {D/IC5/14}. It is
10 paragraph 5.5. Do you have that, Mr Bezant?

11 A. I do, thank you.

12 Q. This is the part that you summarised.

13 A. Yes.

14 Q. 5.5. But the bit you did not summarise is the last
15 sentence before the bullet points which he says, in
16 referring to an example for tariff changes of 2015,
17 I will read out a bit without saying anything too
18 exciting:

19 "The following points bear emphasis as they
20 illustrate the fact that Parcelforce's updates to its
21 Tariff ..."

22 Then I will stop and just invite you to read to the
23 end of the sentence and indeed read the bullet points,
24 please. (Pause)

25 A. I have read all the bullet points, thank you.

1 Q. What I am putting to you is that if we go back now to
2 the joint experts' statement, which was your tab 7 and
3 for us it is {E/83/65} -- probably we should have the
4 confidential just so that everyone can keep it in mind,
5 {E/IC83/65}. When you say, in the text above the
6 quotation, that the use of contribution margin supports
7 a relationship between costs and prices, what it does
8 not do is demonstrate that prices were actually higher
9 because of the very, very small increments of
10 overcharge. Plainly, this contribution level was just
11 one factor among many. It was not cost-plus-type
12 pricing.

13 A. It was not cost-plus-type pricing. The contribution
14 margin is in effect a cost-plus concept but it was only
15 one of the factors.

16 Q. So we cannot conclude, can we, that the prices are
17 actually higher because of the overcharge?

18 A. In respect of these particular tariffs -- again, these
19 are things I have looked at in the round because of some
20 of the level of information available on Parcelforce.
21 But on this particular subset, if there were more
22 factors or if they became the dominant factor, then no,
23 we cannot conclude that cost-plus pricing was adopted.

24 Q. Let us look at the next page, {E/IC83/66}, K.6. This is
25 where we get to talking about the bespoke rates. You

1 say:

2 "Mr Bezant understands that the contribution margin
3 has been a key consideration in Parcelforce's pricing
4 process for its bespoke rates ... In particular:

5 "Parcelforce has modelled the costs in respect of
6 specific customers' dispatch profiles;

7 "Individuals ... have used pricing models to
8 estimate the contribution margin ...

9 "Bespoke rates have been subject to a set authority
10 structure in which lower contribution margins ...
11 require a higher authority ..."

12 Then you again say that:

13 "... the above evidence supports a relationship
14 between Parcelforce's costs and its bespoke rates."

15 But can I again show you what Mr Cahill said about
16 this, for which we need to go back to bundle D. It is
17 tab 26 for you, please. Bundle {D/IC5/17}. This is
18 where Mr Cahill is talking about the costs model that
19 you talked about and he was cross-examined on as well.
20 He says, 5.17:

21 "Since the late 1990s, the bespoke price setting
22 process has worked broadly as follows: a sales person
23 fills in a form which gives general details about the
24 customer and their business, including annual volume,
25 the products they intend to use, size of parcels,

1 whether the parcels are machineable ... etc. Since
2 around 2012 ... it has been possible to input these
3 different factors into ... [the] pricing models as cost
4 drivers to produce the estimated cost ... and estimated
5 contribution margin if we price at a particular level."

6 Then he gives the example that he was cross-examined
7 on:

8 "The cost drivers in the pricing model mirror those
9 in the contribution model and the pricing model can
10 therefore be used to estimate the level of ... charge
11 that would be associated with a particular customer ..."

12 Then, at 5.18, this is the important point:

13 "The price that we input into the pricing model is
14 the price that we think we need to charge in order to
15 win the customer's business ... We input the price
16 manually (it is not suggested by the model) and the
17 model allows us to understand the kind of margin we
18 would make if we price at that level. The level of
19 contribution margin generated by the model typically
20 dictates who can sign off ..."

21 Then he says at the bottom of the page:

22 "It is important to bear in mind that the pricing
23 models used as a part of the pricing process do not
24 define the rate charged ... [It] simply allows
25 Parcelforce to understand the rate at which it would

1 need to price in order to achieve a particular level of
2 margin."

3 MR BEARD: Sorry, I am slightly concerned because this is
4 material for Mr Cahill which I cross-examined on in
5 relation to the 2007 model itself which --

6 MR WARD: I am going to show him now the transcript.

7 MR BEARD: Lovely.

8 MR WARD: If we can now look at the transcript, I do not
9 think you have this in your bundle, I am afraid,
10 Mr Cahill, but it is {Day6/57}.

11 THE EPE OPERATOR: Day 6 is confidential.

12 MR WARD: I am so sorry. I will have to read it out. At
13 page 57, lines 11 to 15 {Day6/57:11}, Mr Cahill says:

14 "... this model would be used to build up the costs
15 relative to the price that the salesperson needs to tell
16 us what margin that would be at, which would then define
17 who could sign it off ..."

18 At page 51, at line 15 {Day6/51:15}, he said:

19 "I think it is important to state there is another
20 sheet to this model -- it might be in the other -- that
21 has inputs for the price and generally we would like to
22 do an input of a price. So a salesperson would have
23 a conversation with a customer and they would ascertain
24 the price to try and win the business, along with other
25 factors. The key bit around the margin is who is able

1 to sign that off within our pricing governance."

2 So what I am putting to you is only not that this
3 margin is irrelevant but, once again, it is just one
4 factor in a wider pricing process. It does not enable
5 us to conclude that tiny increments of overcharge
6 actually led to higher prices. Would you accept that?

7 A. I think -- I was not here for Mr Cahill's evidence.

8 I think there was something -- I will tread carefully --
9 to do with different generations of the models and
10 whether they were contribution-based, in which case
11 costs would flow through to prices, or whether there was
12 a price-based tab that might be the other way to do it.

13 I think that in the earlier models, which covered
14 most of the period we are talking about, there was no
15 price tab, if I can put it like that, only
16 a contribution tab, and I think in the models attached
17 to this witness statement, to the extent the price tab
18 is there, it is naked. There is no information in it
19 that shows it has been used. So there is a question as
20 to what was actually done at a moment in time.

21 Earlier in the period, they were not inputting
22 prices to see what the margins were, if I have
23 understood it; they were inputting contributions to see
24 what the prices were and seeking authority by reference
25 to that. But contributions build off of costs. So I am

1 a bit reluctant to dive into what I think is a factual
2 matter, but I am not sure it fully supports what you are
3 asking me.

4 Q. I have obviously taken you through what Mr Cahill said
5 in his evidence.

6 MR BEARD: I am sorry, that is not correct. That is not the
7 full exposition.

8 MR WARD: I have taken him through what he said in his
9 factual witness evidence and the point I am putting here
10 is not that margin is nothing to do with it, obviously
11 it is, but there are wider commercial factors in play in
12 addition. That is all I am saying.

13 A. So I think I agreed with you earlier that there are
14 wider commercial factors but, by reference to the
15 models, I am not sure, as I have just said to you, it
16 leads to that conclusion, because it depends which
17 models at which moment in time.

18 Q. I am not seeking to argue with you over that but the
19 models themselves are only one element in that process.
20 That is what I am putting to you.

21 A. Yes.

22 MR WARD: Thank you, sir. It is now 4.45 and that in fact
23 would be a convenient moment for me.

24 THE CHAIRMAN: All right, good. Excellent. By my
25 calculation, you have had about two hours.

1 MR WARD: I get a total of three and a half, do I not?

2 THE CHAIRMAN: Well, it is up to you. It is up to you but
3 it will impact on finance.

4 MR WARD: I think I started on 2.45.

5 THE CHAIRMAN: Yes, correct.

6 MR WARD: Good. I will keep that in mind.

7 THE CHAIRMAN: How long do you think you will be tomorrow?

8 MR WARD: Well, probably until lunchtime is a good central
9 case estimate. Put it that way.

10 THE CHAIRMAN: Well, we will start at 10 o'clock tomorrow to
11 keep the same length of days, if that is okay with
12 everyone.

13 Yes, and of course you are still giving evidence so
14 you know the rules not to talk about it with anybody.

15 All right. 10 o'clock tomorrow.

16 (4.45 pm)

17 (The hearing adjourned until
18 Wednesday, 8 June 2022 at 10.00 am)

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