IN THE COMPETITION APPEAL TRIBUNAL

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

Salisbury Square House
8 Salisbury Square
London EC4Y 8AP

Wednesday 8 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 Cliodhna Kelleher (On behalf of RM/BT)
Daniel Beard QC, Daisy Mackersie and James Bourke (On behalf of DAF)

Wednesday, 8 June 2022

(10.00 am)

MR WARD: Sir, before we begin, can I just update you on loss of volume?

THE CHAIRMAN: Please do.

MR WARD: I think you were told yesterday my solicitors had written a letter to Travers making some proposals to narrow the issues. We gather a reply is on its way but has not yet been received.

THE CHAIRMAN: Okay.

MR WARD: Oh, it has just been received. Oh, there we are. We have not had time to consider it but we shall.

MR BEARD: My understanding is the reply suggests that we can narrow the issues. It would still be more efficient to operate a short hot tub, if that were possible, because that will curtail the process effectively of cross-examination. That is the proposal that has come up.

THE CHAIRMAN: If we can see the narrowed issues that would be a great help.

MR BEARD: That is what we were -- we were trying to get them agreed but there was some discussion overnight, and I am sorry for the delay in responding to BCLP.

THE CHAIRMAN: No, that is fine. That is fine. Well, if we can have them during the course of the day or --

MR BEARD: Yes. No, completely understood.
THE CHAIRMAN: -- just after close and then we will sort out the topics that we actually want to be considered.
MR BEARD: Yes, of course. These are only humble suggestions, of course.
THE CHAIRMAN: Understood. All right. Great.
MR WARD: Just one other thing to explain, sir, if I may before I begin; indeed I address Mr Bezant at the same time. I am going to ask questions about BT supply pass-on, but then I am going to ask a few questions relating to loss of volume. The reason is that Travers wrote a letter to my solicitors last week, essentially saying, well, if I can paraphrase, Professor Neven has relied on Mr Bezant's analysis --
THE CHAIRMAN: Yes, I think we have seen that.
MR WARD: -- and therefore they said, "Well, if you have got questions on that, you need to put them to Mr Bezant". So that is what I am going to do. But I am going to do that right at the end if that is convenient for everyone.
THE CHAIRMAN: Yes, absolutely. There is no object to that I assume?
MR BEARD: No, that is entirely proper.
MR WARD: Thank you.

MR MARK BEZANT (continued)

Cross-examination by MR WARD (continued)

MR WARD: Good morning, Mr Bezant.
A. Good morning.
Q. Now, I want to start with BT, as I have said, and here, of course, the position in terms of charge controls is much more complex than Royal Mail, is it not? By which I mean we have a large number of charge controls and various different business units regulated in different ways at different times?
A. It is a complicated regulatory environment, I agree with that.
Q. I will take that as a yes.
You have focused on Openreach largely in your analysis?
A. Yes, not exclusively, but largely, given it is the bulk of the supply pass-on issues.
Q. You say 77.32 and Mr Harvey says 75 --
A. Yes.
Q. -- in terms of percentage.
I am going to focus on Openreach, but I am also going to try and make points of wider application for that reason, and in particular we saw in the joint expert statement, you agree the position is likely to be similar for BT Wholesale, which is the predecessor of

Openreach.

A. Yes, that is precisely why I focused on Openreach, because it extends into wholesale, many of the issues extend into there.

Q. Well, let us try and get a scale of the overcharge relative to Openreach's business, shall we? If we could open your tab 8 and our {E/7}, please, and we want to go to page 68 {E/7/68}.

A. I have that, thank you.

Q. Thank you.

We see at the bottom of the page, just indicatively for one year, 2015 and 2016, that the revenue of Openreach is £5.1 billion and the total BT Group revenue is £8.9 billion [sic]. That is why, as I mentioned yesterday, Mr Harvey concluded that the total overcharge was worth less than 0.003% of Openreach's revenues over the period. You will remember we mentioned that figure yesterday.

A. I do.

Q. But we can also see that, on the next page {E/7/69}, Mr Harvey carried out an exercise of attempting to allocate the overcharge to the different lines of business within BT at 4.10, divided into three key markets. Do you have that?

A. I do, thank you.

Q. Thank you.

I do not think you have challenged this, although Mr Harvey is very clear that this is just an estimation; these are not intended to be hard and fast figures. Just for the tribunal, to explain what these acronyms mean, "WNBA" is wholesale narrow band and that involves voice. If one thinks of that as voice, that would be good enough. "WLA" is access to BT infrastructure such as local loop; in other words where the final mile, as it is sometimes described, of copper is provided by BT, but other providers such as Sky or TalkTalk plug into that infrastructure, that is local loop unbundling. Then "BCM" is business connectivity, which is providing things like leased lines to businesses. All that is explained in the reports but this is just shorthand for now.

Happy with that, Mr Bezant?

A. Yes.

Q. Thank you.

What we see is that Mr Harvey carried out a sort of estimation based essentially on revenues applied by reference to which business division we know used the trucks. We can see at page 71 {E/7/71}, for example, just to try and get a sense of this, this is table 7, this is WNBA, which is voice, and if we look in the fourth column, this is depreciated value of overcharge for analogue WLR, which is wholesale line rental, so we are talking about voice line rental. We see figures ranging there from about 19,000, right at the beginning, annually, and then if we turn over the page {E/7/72}, we can see, for example, 2007/2008, 143,000, and then again tailing off again towards the end of the period.

You have not, I think it is fair to say, disputed or endorsed these figures?

A. I have commented on the products that he has looked at but I have not sought to challenge the maths of these tables --

Q. Yes. Fine.

A. -- as far as I recall. There is a lot of material in my report, but as far as I recall.

Q. No, no, I do not think you have either. I just want to be clear, we are not relying on these as absolutely right, but as essentially indicative.

Then, in the next table, table 8, which is WLA, which is wholesale local loop unbundling, access to BT's final mile of copper, putting it very simply, we see the depreciated value of overcharge ranging from 0 up to I think the highest year is 23,000. It is just worth dwelling on 2007/2008, where we see the value of overcharge is 16,984. Now, it is right to say, as you will have seen, Mr Bezant, that Mr Harvey acknowledges that this could be understated because it does not include BT's internal use, if any, of these products at that time due to a change in the way the RFS were calculated. I am sure you will recall that.

A. I do not recall that precise point, but if it is in his report, it is in his report.

Q. It is in his report.

Just -- I am really doing this to get a sense of flavour.

Would you accept that within these three broad market categories that we have been talking about, there are actually quite a lot of different individual products, both main products and then ancillary products?

A. There are -- yes, again, I would need to look at the detail, but yes, there are products obviously within these categories.

Q. So what we are looking for here then, in terms of trying to decide whether pass-on occurred, is extremely small sums of money spread across quite a lot of products, even within these different market categories.

A. So the costs are spread across a lot of products within different categories, I agree with that, and if the costs had been different, they would have been spread across the same set of products, only differently.

Q. But the increment that we are looking at here is, relatively speaking, absolutely tiny, is it not?

A. It is a small difference, but we explored this yesterday.

Q. We did.

A. The process would have been to allocate whatever costs were to be allocated.

Q. Yes, absolutely, and then the ultimate question is whether that would have actually led to higher prices, as we have discussed.

Now, if we turn to the joint expert statement, which is tab 14 for you, and for us it is {E/84/29}, page 29, please. What we can see, under G.1.4, is four types of charge controls for Openreach. Glidepath accounts for about 55%, and then there are extensions, charge ceilings or fixed price caps around 27, and then cost orientation and fair and reasonable obligations, 15. I am going to talk to you at least a little bit about each of those, and indeed each of those has applications outside Openreach, although I think cost orientation is only Openreach and wholesale.

A. Again, there is a lot of detail, I will take it without checking.

Q. That is fine. Nothing is going to turn on it for this morning.

So let us start with glidepaths. I want to just get clear the nature of a glidepath control and for this I would like to go to tab 30 in your bundle and for us {I4/56}. This is the leased lines charge control -- sorry, I was just explaining while you find it. Tab 30, or at least I hope it is there.

A. Right. I have that, thank you.

Q. Lovely.

If we can turn to page 33 {I4/56/33}. The details of this charge control do not need to concern us this morning, but this is Ofcom explaining why it is using an RPI X form of charge control and explaining its nature. I would like to just look at the first four paragraphs here of "Our response" together:

"We have decided to use the RPI-X form of charge control. It is an established way to provide regulated firms with incentives to seek efficiency savings. It also provides a degree of certainty and stability to all industry participants for a defined period.

"A particular feature of an RPI-X form of control is that it gives BT incentives to enhance its efficiency. The charge control entails forecasting expected efficiency gains over the duration of the control and determining the maximum permitted price change for

[a] particular group of [in this case] leased lines services. In order to maintain its profitability ... BT has to make efficiency improvements to reduce its costs in line with the expected path set by the charge control. As noted ... it is the linking of prices to an exogenous benchmark (RPI) which is the key source of efficiency incentives under RPI-X.

"In addition ... RPI-X control also provides BT with incentives to make additional efficiency gains over and above those forecast when the control is set. If it achieves [those] additional efficiency gains, BT would get to keep any profits resulting from those additional savings. Consumers benefit in the longer-term from this incentive mechanism, as these additional efficiency gains can be passed back to them ..."

Then at 3.43:

"The main alternative to RPI-X form of control is 'cost-plus' ... Both RPI-X and cost-plus controls are set to allow BT to recover costs plus an appropriate mark-up ... But with cost-plus regulation, charges are set equal to actual costs including a regulated rate of return ... The key concern with this type of charge cap is that it has poor incentive properties. BT would obtain a similar profit margin no matter what level of costs it incurred. In particular, [it] would have limited incentive to keep its costs under control ... as it can still pass on inefficient costs to customers."

Would you agree with that as a general description of the way RPI X charge controls operate?

A. Yes, you are linking your allowed revenues to forecasts of your efficient future costs and you are linking them.

Q. What it is not doing is what Ofcom is describing here as "cost-plus", which is simply allowing the costs and then adding a margin to allow a rate of return?

A. I agree, it is not cost-plus by reference to the actual outturn. It is costs linked -- sorry, it is revenues linked to expected costs.

Q. Can we now look at the way Mr Nicholson described this in his evidence? This is tab 17 for you and for us this is {D/11/20}. Do you have it, Mr Bezant?

A. I do.

Q. I want to read this to you and again see if you agree with it.

"Ofcom did not design the controls to specifically recover any actual amount of cost in any particular year, and no mechanism existed to deal with under or over recovery of costs in the framework. Rather, Ofcom generated a target total cost for the controlled service with an expectation that it would be broadly challenging but possible for the business to achieve and with an expectation that it was in Openreach's interest to 'beat the cap' through innovation encouraging Openreach to find ways to reduce costs in excess of these modelled by Ofcom. Openreach might keep the rewards of ... innovation during the charge control period and the benefits would be passed on to CPs [meaning communication providers, who are customers] and consumers the next time ... If Openreach did not 'beat the cap', it would bear the costs of failure to do so ..."

Do you accept that so far?

A. Yes. The intention was that -- in a sense, it was symmetrical: they would suffer if they did not make efficiencies and they would benefit if they did make greater than expected efficiencies. But the objective was not -- in a sense, the objective was to hit or regulate against a sensible set of future efficiencies.

Q. But what it is not doing is guaranteeing any particular return, is it?

A. No, it is structured against a set of expected costs based on forecast costs. It is not guaranteeing --

Q. Yes.

A. -- an outcome, but it sets prices, as I have said, against a series of forecast costs that go into that regime.

Q. The accuracy of those forecasts will be one of the things that is critical to seeing if the outturn is achieved?
A. Well, the accuracy will -- the accuracy will be different, or may be different to what is actually achieved. The question is: if you have different costs, would you have a different assumption for your forecasts? Because that is what sets your prices going into that regime.
Q. Let me turn now back to the joint expert statement, about what you say about the way these controls work. This is your tab 14 and for us it is {E/84/32}. At the bottom of the page, you say:
"The Regulator ..." --
Do you have -- do you have it?
A. I do, thank you.
Q. Jolly good:
"The Regulator used ... rounded values of 'X' that it calculated in its financial models ... That is, the rounded values of 'X' that the Regulator adopted in its glidepath charge controls were determined mechanically/formulaically."
I think it is fair to say your view is, if it then exercises judgment over the top of that, that is something, as it were, as an additional step; is that

a fair summary?

A. If it calculates prices by reference to its selected rounded values of X, it gets a price that comes out of that process, and then, if it wishes to make a further decision based on some other judgment, then it would do so.

Q. Good.

What we will do, or what I would like to do is look -- sorry, before I do, it is essentially your case, I think, that this mechanical exercise essentially ensures that even a sum as small as the overcharge would be passed through?

A. I do not say it ensures it. I think it is a reasonable assumption given the facts of the size of the overcharge and the calibration of the models and the objective of the regime, which was to allow BT to recover its efficiently incurred costs, whatever they were.

Q. So whether or not "ensured" was putting it too high, it is certainly your view that it did?

A. Well, my best estimate -- and I have explained why --

Q. Sure.

A. -- is that it had that effect. It may in fact have had a slightly bigger effect because I have left out the cost of capital return within there, but let us not go into that.

Q. Okay.

Well, what I want to do is walk through one example with you which does show a close examination of costs, but also what I am going to put to you, it shows a very large role for regulatory judgment in the setting of these kind of charge controls. It is tab 32 in your bundle and it is {I4/27} for us.

This is "A new pricing framework for Openreach" of May 2009, which you may recall because it is discussed in the reports, including yours.

For what it is worth, we think this is a sort of -- represents a form of high watermark in terms of sophistication. It is not unique, but there are a lot of these that are a lot less sophisticated. Indeed, it is one of two that my solicitors have been able to find that even talk about fleet costs. Not trucks, but fleet costs. So we want to look at it and just try and understand the steps in the regulatory process in addition to the question of costs.

Can we turn, please, to page 1 {I4/27/4} which tells us what it is actually about. It is -- at 1.1, it is a review of double prices for --

THE CHAIRMAN: Is that page 1 what page 4.

MR WARD: It is page 4, I am so sorry. I was looking at the internal numbering. Thank you.

It is a review -- it says this is a review of prices, in the last two lines, for WLR, MPF and SMPF, the core rental services.

WLR, as we talked about earlier, is wholesale line rental, and MPF and SMPF are two important products in LLU. Just for the tribunal's benefit, they are two different ways that a wholesaler, such as say a customer like Sky, can obtain access to the local loop. MPF is a metallic path facility, which enables them to provide broadband and voice over the BT copper wire. In SMPF, shared metallic path facility, the operator like Sky would provide its own broadband, but uses BT's WLR to provide the voice, so it is a question of whether you have both services or just the broadband.

Just for the transcript, there is an explanation of that -- just for the transcript -- in Mr Harvey's first report, {E/7/143}. But we will not go there.
Mr Bezant, I hope you agree with me, my shorthand explanation of what these products are.

A. There are various descriptions in my and Mr Harvey's reports of products. I do not recall each of them precisely, but I am not going to disagree with you, obviously.

Q. Good. Well, that will do for now.

What we see on page 7, please {I4/27/7}, is table 1.2 where we ended up. We see current prices for MPF and SMPF, and then the new price which is going to run from 2009/2010, and we see the prices are set to the nearest 10 pence, £86.40 and £15.60, and an indexation RPI set to half a decimal, to 0.5. So it is RPI plus 5.5 for MPF, and RPI plus 1 for SMPF.

Then, as for the line rental, we can see it says at 1.22, they have decided that until they have carried out another review, the related --

"... the prices for residential and business WLR rental [shall] remain at their current levels, of £100.68 and £110 ..."

So that is actually an example of something we will talk about later which is an extension of price control for WLR. So we can forget about that now.

Then we can also see, at 1.3, there are some basket controls -- sorry, it is table 1.3, yes, thank you -- table 1.3, basket controls on ancillary services put to one decimal place, 3.0 and RPI plus 4.5, and there are a lot of these services in this price control.

Will you take that from me or would you like to see?

A. No, that is fine.

Q. Now what I want to do is just look at what is involved, because we have spent a lot of time in the last two days talking about cost, but there are a lot of other factors that go into Ofcom's thinking, as I hope you will agree.

Let us start, please, on page 14 {I4/27/14}, where Ofcom recites its statutory duties. It says, 2.28:

"Under the Act, our principal duty in carrying out functions (such as ... the present proposals) is to further the interests of citizens in relation to communications matters and ... further the interests of consumers in relevant markets, where appropriate by promoting competition."

Then, it says:

"In so doing, we are required to secure a number of specific objectives and ... have regard to a number of matters, [under] section 3 of the Act. As ... prescribed specific statutory objectives ... we consider that the objective of securing the availability throughout the UK of a wide range of electronic communications services objectives as particularly relevant ...

"In performing our duties, we are also required to have regard to a range of other considerations, as appear to us to be relevant ... namely:

"The desirability of promoting competition ...

"The desirability of encouraging investment ...

"The desirability of encouraging the availability and use of high speed data transfer ..."

Then at 2.32 {I4/27/15}, it says:

"Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives. In so doing, we have taken account of all relevant considerations, including responses received during this consultation process ..."

I hope that was not drafted by one of my learned friends, but in any event that is what they say.

Of course, in terms of consultation, you probably will not be surprised to hear that the consultees included its wholesale customers, and would you accept that they are likely to be asking for rather lower prices than BT wants?

A. Likely, but they are -- also everybody is interested in understanding how the prices have been arrived at in great detail.

Q. Yes.

So what we see here, would you agree, is Ofcom making clear it has to take into account a wide range of both third party and even public interest considerations in setting its prices?

A. It has to take into account a range of considerations in setting the regulatory regimes, which include the pricing mechanisms adopted for different products over time and the different groups of products, so, yes, they apply that discretion and arrive at different price control or other mechanisms, as you can see.

Q. Yes. So not just in the round, but in the specific, in the specific --

A. Yes.

Q. -- of setting these prices.

So what we can see, would you agree, is that this is anything but a mechanical exercise?

A. So the exercise involves a great deal of consideration and consultation. At the end of it, they determine a suitable mechanism for setting prices or a suitable regime for setting prices, and they do so for different products and that may change over time, but that is what they do. Then within that, they apply the inputs, as we have discussed.

Q. They do indeed, as we will see. But really what I am putting to you, and I am going to put to you later, is it just not a mechanistic process where the inputs go in and the charge control comes out?

A. So they choose the particular form of price regulation, as they think is appropriate for the product with all the competing considerations. Once they have that particular regime, they apply it. What we are dealing with is the application of a given regime to a particular product --

Q. I am sorry. Mr Bezant, if you are saying that all of these duties and this public interest consideration and the consultation is only relevant to the exercise of deciding what type of price control to select, that is plainly not what Ofcom is saying.
A. No, that is not what I am saying.
Q. Good.
A. So they make a series of deliberations. We are looking at the -- and they make those deliberations, as we have discussed, taking a series of factors into account. If they elect on a glidepath control mechanism, having concluded on that, say, or any other mechanism, they apply it; right? That is one part of the process. There are deliberations, but one part of the process is selecting that mechanism.
Q. Yes, I think you are still trying to ringfence out of that --
A. No, I am not. I am not. I am just answering your question.
Q. Okay. Well, all right, we will take your answer, but I have put my case: there is plainly a broad exercise of discretion going on here --
A. Yes.
Q. -- even within the setting of the price.
A. Yes, and that is what I have said, and they change the

price control, from time to time and from product to product, in the setting -- in the exercise of that discretion.
THE CHAIRMAN: I think what is being put to you is that not only in setting the type of price control that they have chosen to adopt, but in actually carrying out that, it is not a purely mechanistic process, there are discretions --
A. Yes, there are discretions.
THE CHAIRMAN: -- and judgment comes into that.
A. Yes, there are discretions. I am not disputing that.
THE CHAIRMAN: All right.
MR WARD: Even the setting of the actual price is itself an exercise of judgment and discretion. That is the point I am just not sure you are on board with, Mr Bezant?
A. Well, I think one would have to look at the particular regime and what is happening within that regime for a particular product, but there are discretions, but they vary and they change.
Q. Let us look on the next page, which is page 16 internal {I4/27/16}. It says again:
"Our objectives for this review.
"Informed by stakeholder responses ... we set out our updated specific policy objectives for this review ... as follows:

"To promote efficient and sustainable competition ...
"To provide regulatory certainty ...
"To ensure ... the delivery of the regulated services is sustainable ... and
"To maintain incentives ..."
A. The bit you did not read was:
"... the opportunity to recover all [the] relevant costs ... including the cost of capital ..."
Q. Absolutely. Absolutely. Well, that is what is meant by sustainability. But what I would say is that -- what I would suggest to you is that this is all a much more complex exercise than simply guaranteeing a mechanistic recovery of even very small increments of costs.
A. So, there is a complicated process of selecting price control regimes, I agree with you. Within that, there are implications of how one goes about considering the costs that are relevant to a particular product by reference to the price regime applying to that product.
Q. Let us turn to page 21 {I4/27/21}, where they say, 4.1:
"In the Second Consultation, we set out our view on the financial case for price changes for the Core Rental Services based on our assessment of the unit costs for each ... [service], and the assumptions taken into account ...

"We invited stakeholders' views on the cost calculations and the underlying assumptions."

So even the content of the cost control is something that they regard as having third party interests that need to be taken into account; would you agree?

A. I would.

Q. Then what we see, at the bottom of the page, is they start with Openreach's -- 4.7, Openreach's own cost and revenue projections for the core rental services for the period of 2012/2013, derived from Openreach's own model.

If we turn the page {I4/27/22}, we will see here that table 4.1, we can see the first column, 2007/2008, is identifying revenue of £2,687,000,000, operating costs of 1.636 billion, then there is in there a line for fleet -- unusually, but it is there. Unusually in that it is itemised in this way. The fleet item is there at 87 million, rising -- projected to rise to 2012/2013 to 95 million.

Now, we discussed yesterday that the fleet cost in BT -- that fleet itself is 90% vans, if you recall, and that the fleet charges include non-capital costs. Do you recall that?

A. Yes.

Q. So on average, if you like, the fleet cost will involve a lot more than trucks and an awful lot more of an

overcharge; would you agree?
A. Yes.
Q. In fact, there is no information here at all, is there, about whether the fleet cost that they are talking about is fleet in terms of trucks or, say, Openreach-type vans or anything else?
A. Not in this table, but they allocate all of their costs to all of their products based on very careful analysis of the usage of the resources to which the costs relate. So the truck costs find their way into the activities and products that use trucks. As with every other cost they are allocated in to the products.
Q. Absolutely.
But what we cannot see here is what element of the fleet cost might in fact relate to trucks on this occasion?
A. No, we cannot, but I do not have a reason to believe that the truck costs are not included.
Q. To the extent they are used?
A. To the extent that the product in question uses truck costs, or somewhere upstream it has used truck costs if another part of BT is using some -- some other part of BT.
Q. Yes, but it remains a black box as far as this analysis is concerned, does it not?

A. It remains a summary as far as this analysis is concerned.
Q. I will take that. But we saw a few moments ago Mr Harvey's estimation is that, for LLU, which would include these products, MPF, SMPF and the ancillary baskets, that the overcharge for 2007/2008, he estimated was £16,984.
A. Right.
Q. So that certainly might not be precisely right, but it is the kind of order of magnitude that we are talking about against this cost stack of -- well, it is 1.6 billion, including WLR, and 87 million for fleet, whatever exactly fleet means.

Then if we look below the table, we see, at 4.9, Ofcom says:

"... we remain satisfied that our approach to modelling Openreach's costs provides an appropriate basis ... We remain of the view that Openreach's own view of future costs, if appropriately challenged and adjusted, potentially provides more relevant data ... to start our own analysis of costs in the period to 2013 than audited regulatory accounting [documents] ..."

So, in other words, it is saying we are happy to use BT's model, provided we adjust it.

Then, if we look on the next page {I4/27/23}, at

4.11, they say --

A. Well, it says, if challenged, you adjust it appropriately.

Q. Exactly.

A. Yes.

Q. 4.11:

"... as explained in the Second Consultation, while the overall approach seems sensible, the reasonableness of the cost projections depends on the underlying assumptions. We explained in the Second Consultation that we did not agree with all of the assumptions proposed by Openreach and considered its cost projections were overstated ..."

Then we can see table 4.2, which runs on for three pages, "Summary of key assumptions", on which Ofcom stated a view in its indeed second consultation, then obtained additional information, and then reached conclusions.

Is this familiar to you, Mr Bezant?

A. It is -- this particular document I have not looked at recently, so this table is not.

Q. If we just skim down the first page, we can see the kind of things, where the parameters are "aggregate volumes", change in mix of products, "change in mix - internal", "change in mix - external", "change in mix - other", "inflation". Then, over the page {I4/27/24}, pay, pensions, and then we can see, towards the bottom, "scope for efficiency ...", three from the bottom, "cost allocation", and all sorts of other things. On a lot of them, but not all of them, Ofcom is disagreeing with BT.

Then, at 4.14, underneath this lengthy table {I4/27/25}, it says:

"... we have projected what we consider to represent a reasonable estimate of Openreach's costs and revenues ..."

Would you accept that is not the language of high precision, "reasonable estimate"?

A. Well, it says they have reached a reasonable estimate. What level of precision is a separate matter. Some of the models -- well, actually, the models I have seen are highly precise. Highly precise at the level of costs --

Q. Okay. Well, I am only going on what they are telling us?

A. Well, this is a summary, but when you look at the models, they are highly precise.

Q. If we turn to the next page {I4/27/26}, we will see the, at table 4.3, cost estimates, and what we can see is the line for "Fleet" goes from 84 to 72 million compared to the 87 and 95 million that we had in Ofcom -- Postcomm -- sorry, BT's model.

Then the operating costs have been cut substantially from 1.4 billion -- down from 1.4 billion to 1.295 billion, compared to BT's proposal, which was 1.636 billion to 1.531.

A. I see that, yes.

Q. So significant adjustments have been made here, have they not, using Ofcom's regulatory judgment?

A. Yes.

Q. Then, over the page {I4/27/27}, we can see it then derives unit costs for both MPF and SMPF. Indeed, we can see, if we look at the bottom of the page, for MPF, {I4/27/27} -- we seem to be seeing something different to me -- sorry, it is my fault, next page, {I4/27/28}. Total unit cost for MPF, and if we look at line 2009/2010, which is the first year of the charge control, it comes up with a cost of £87.20. Then, on the next page {I4/27/29}, 2009/2010, for SMPF, the total unit cost is £13.18.

But it does not stop there, Ofcom's analysis, because the next section of the report is called "Implications for prices". We can pick this up at page 31 {I4/27/31}. It says:

"... we set out our assessment of the fully allocated current cost ... of providing the Core Rental Services [which we have just looked at]. In this

Section, we explain why we have placed considerable weight on this cost evidence [considerable weight] in deciding how to modify the price control for MPF. We also set out the ... factors that we have taken into account ...

"We explain that:

"We have placed significant weight on CCA FAC in determining the ... charges for the Core Rental Services."

So would you accept "significant weight" is not the language of "we absolutely apply this and we guarantee recovery of it"? Weight is one of a number of factors?

A. They have studied the fully allocated costs, carefully, and put significant weight on it. The fully added -- allocated costs include all of the costs including truck costs to the extent they are relevant to the product.

Q. Then:

"We have also considered the potential impact of price changes on ... competition and consumers;

"In assessing cost and charge levels, we have also taken account of other sources of evidence, including international price benchmarking;

"We consider there is a strong case for using a glide path ...

"We also consider there is a case for a price path that involves a larger increase in the MPF charge in the first year."

So what I am suggesting to you here is that we have a wide range of considerations, not just cost. Would you agree with that?

A. There are a wide range of considerations in determining the pricing regulation to apply. They have taken a number of things into account, including efficiency that is desired, including competition and including the costs, historical and prospective, because that is what they were doing.

Q. Then the final piece in the puzzle that I want to point to is on page 33, under the heading "Dealing with uncertainty" {I4/27/33}. At 5.20:

"In the First Consultation, we noted that the FAC costs estimates are highly dependent on the assumptions on volume and mix of services, which must be considered to be particularly subject to variation in the current economic climate."

Pausing there, of course this is the middle of the global financial crisis.

"We noted that substantial variation from the expected volumes (both internal and external) will influence the long term direction of pricing and would be a factor when we come to re-assessing the price controls direction after two years."

Then, over the page {I4/27/34}, at 5.24:

"We accept there is a forecast risk, but given the relatively short duration of the price controls and the advantages noted by Openreach with respect to regulatory certainty we propose ... barring unforeseeable dramatic changes ... we would not plan on a review ..."

So, Ofcom there is recognising again that it has a considerable degree of uncertainty in this charge control because of the economic situation in particular. Would you agree?

A. Yes, and it sets its prices by reference to its assumptions, notwithstanding the uncertainty.

Q. Well, with respect, that is right, but also what is clear is that it sets its prices in a way by recognising there is a great deal of uncertainty.

Then what I would like to show you is what it then says about setting the price of MPF. We can pick that up at the bottom of page 47 {I4/27/47}:

"As explained below, we have determined the appropriate glide path for MPF in four stages.

"First we considered what a four-year (real terms) --"

A. Are you on page 48 now? Sorry, I am just trying to keep up with you.

Q. Yes, sorry, over the page {I4/27/48}:

"First we considered what a four-year (real terms) glide path would look like ...

"Informed by that glide path, we then determined the appropriate starting charge for MPF ... giving weight to alternative methods ... including the case for full cost recovery ... We adopt a value close to the middle of the range ...

"Having established the appropriate starting charge ... we determined the appropriate glide path over the remaining three years ..."

Then:

"We ... defined the X ... to reflect the RPI ..."

There was a lot of confusion over -- difficulties over inflation in this period due to what now seems quaint, the risk of deflation that was perceived at the time.

Where we get to, at 7.32, is:

"Our analysis suggests that a 'true' real terms increase of approximately 1.5% per annum is needed to allow prices to move towards full cost recovery ...

"However, in order to deliver this real terms increase ... we have adjusted the X to allow for the expected difference between the reported RPI ... and the actual RPI ..."

So they are worrying about what inflation will really do.

"The difference is significant -- approximately 4%. On this basis, we consider that an X of 5.5% is appropriate ...

"... this means that, if inflation is in line with our expectations, the MPF price will increase by around 4%, from £86.40 [which is the relatively round number that it has alighted upon] to around £90."

Well, all I am putting to you, Mr Bezant, is that this is a complex exercise, but there are layers and layers of regulatory judgment involved as well as cost analysis, and where we end up is indeed the language of approximation where Ofcom is reaching a judgment about what prices to apply. Would you accept that?

A. So they are setting out how they are going to go about this. They are thinking about the measure of inflation, right, and that is one of the parameters in the model. Projected costs are another, because they are trying to match and recover efficiently incurred projected costs and allow a capital return.

So that is the model they are considering.

The question is, if they have a different set of costs, they are not going to change their view on inflation. So this is the assumption we have made about inflation, but they are going to run the model with the same inflation assumptions and maybe a different set of costs and it may generate a different price, because they have considered various things, some of which will change if your costs change, some of which will not change, your view on inflation, your view on cost of capital, for example. So the question is within the model they have alighted, within the judgments they have made, they have arrived at a price.

Q. Yes, absolutely. The ultimate question for us in this tribunal is whether it is likely that the overcharge actually made a difference to the price that they decided upon?

A. Yes, once you put it through --

Q. Once you put it through --

A. -- the same process.

Q. -- all of this process.

A. Yes.

Q. Can I take you for this purpose -- we can put that away now, but if we can go to your tab 8, this is Mr Harvey's first report again, where he has done calculations, or estimations at least, about the size of overcharge we are talking about. This time, we want to go to page 159, please, it is {E/7/159}. This is where he has carried out an estimation of how much overcharge might be involved in MPF rental costs for 2009, which is what we have just been looking at.

Just above the table, he says:

"Taking the estimated impact of the overcharge on MPF rental costs (£5,428) alongside the total costs (106 [million]) implies that the overcharge accounted for 0.005% of total MPF rentals costs (assuming that the overcharge was indeed contained in [the] calculated costs for the service)."

What I am putting to you, Mr Bezant, is it is simply fanciful to suggest that a sum as small as this can be traced through this complex regulatory process involving great elements of judgment to actually mean that these prices were higher.

A. So for a given product, the effect may be nil. For a given product, the effect may be more than nil. This was discussed yesterday because, once you have made a whole series of judgments, decided to use a particular process, inputted the costs into that process to understand the implications for price, then the answer may change if you change your costs, because they are part of the process. So it may change depending upon the inputs. We do not have the models to test this factually, we do not have the models, so we have to -- and we discussed the probabilities of things changing

and so on, and the implications of that, so that is the world we are in.
Q. So it would be fair to say, would it not, that you do not know whether the overcharge could have made -- would have made a difference here?
A. I think Mr Harvey and I agree that if we had the models, we could test them and then we would know, but we do not have the models. They are not available to us, so we work with -- well, when I say that, we do not have all of the models, we do not have the final models, but we can test the models we have, and, naturally, that is what we have worked with.
Q. That is what you have worked with. The central point I am putting to you, illustrated by this, is the overwhelming likelihood is that the overcharge is just too small to matter in this regulatory process.
A. I do not think that is where I am and I do not think that is where Mr Harvey was yesterday. I hesitate.
Q. We will make submissions about all of that later, but I am certainly putting to you our case that it is simply -- the overcharge, as a whole and when looked at in particular here, is too small to matter in the face of this great exercise of regulatory judgment that Ofcom carries out.
A. I have explained why I think the overcharge can matter

within the regime deployed here and I have explained how I think you can estimate that given the information available to us, and that it does have an effect.

Q. Thank you.

THE CHAIRMAN: Are you saying that the judgment of Ofcom comes in when they are deciding which model to adopt, and then it is just a purely mechanistic process once you have decided the model?

A. The judgments come in at a whole series of steps, obviously, in deciding the model to adopt, having thought about the product and heard consultation about what you are trying to achieve and what you desire. So that is one set of judgments in a sense that is frozen: we are going to use this kind of model for this kind of product at a given moment in time. It is selected rather than frozen. So then they go in to the process of establishing or implementing that model to determine costs and prices.

So then -- and what the prices will come out, at that stage --

THE CHAIRMAN: You say there is no further judgment exercise, once the figures go into the model, you cannot -- you have already decided the parameters of it and how the model is going to work, and it is just then a mechanistic process, you say, and there is no further judgment?

A. Well, there may be further judgments around -- it depends a lot on the detail; the price caps across a basket of similar products, for example, there may be judgments there. But once you have selected a particular form, in this case the glidepath, you get an outcome, you get an answer, and that is the price. There is always regulatory judgments, but that is the price that comes out of the model and that is the price that is set and that is the price that BT work to.

MR RIDYARD: One question that has come up is whether this is mechanistic or not and, obviously -- well, it seems like lots of it involves lots of judgments about all sorts of different things.

A. Yes.

MR RIDYARD: You know, how much to give in to Sky if they want to have lower prices and how much to do this, that and the other. But is what you are saying, all those factors are there, but they will be there in the actual and the counterfactual?

A. Precisely.

MR RIDYARD: The one thing which is mechanistic is the fact that one of the factors in all of that kaleidoscope of factors is the cost base and that will differ between the factual and counterfactual? So whatever these discretionary elements are, they will be there irrespective, but what is changing is the cost base, you know, in the counterfactual and the factual?

A. Precisely.

MR RIDYARD: Therefore that element is mechanistic, even if it is only 0.0005, or whatever the number was, of total costs?

A. Precisely. I am not -- to the extent there are other judgments, I do not see that they would differ --

MR RIDYARD: Yes, between the actual and the counterfactual.

A. -- between the actual and the counterfactual. Your view on inflation, your view on 3% efficiency factor, they are not going to change if you change your truck costs because they are not connected to the truck costs. So a lot of the judgments are common to both scenarios. So, as I say, you then have a different set of costs, and within that that gives you a different set of prices.

Or it may give you a different set of prices, excuse me, that is the challenge, but it mechanistically generates a different cost -- a different price in the first instance.

MR RIDYARD: Whether it gives you a different price depends on whether it happens to trigger one of these --

A. Precisely --

MR RIDYARD: -- these lumpy sort of --

A. Then we are into -- go to the secondary question as to whether we fall short of a hurdle or we go over a hurdle and the price moves.

MR RIDYARD: Yes.

MR WARD: I am going to turn to that now, if I may, which is the value of X.

Can we look at your first report which is in tab 9 of your bundle and for us it is {E/26/168}. This is where you are talking about glidepath controls generally. At 15.5, you say:

"... I identify that glidepath charge controls were an important price control adopted by the Regulator and, whilst in principle, the Regulator sought to set prices such that revenues would be brought in line with the forecast cost base (plus a ROCE) over the control period, in practice, when determining the 'X' parameter of its glidepath charge ... it rounded that parameter to the nearest 0.1% or 0.25%.

"Given this process, to assess the glidepath ... controls ... and resulting prices in a Counterfactual ... in which BT (and therefore Openreach) did not incur any alleged Overcharge, I would need to:

"Identify the Regulator's underlying models ...

"Adjust each of these models by the level of any

Overcharge ... and

"Apply the Regulator's rounding criteria ..."

I think what you say is you do not have access to those things. Of course, none of us have those regulatory models?

A. Not all of them and in their final form.

Q. Yes.

A. Or not in their unadapted form. Certain models were presented with information anonymised, so you can use them, but they are not the precise model.

Q. They are not going to answer the question.

Then you have a go at answering the question anyway on page 170 {E/26/170}, 15.11, and you say:

"In principle, a lower cost base would result in the calculation of a different unrounded X [unrounded X] and hence would be reflected in a lower level of regulated prices. However, because of the Regulator's rounding of X, for a given level of Overcharge, the effect on each of the Regulator's glidepath charge control ... will be either: (i) proportionally greater than the Overcharge; or (ii) proportionally less ... depending on the direction in which any rounding occurs.

"In the absence of the final glidepath charge control models ... it is necessary to make an assumption ..."

Then you say, at 15.13:

"Given: (i) that a governing principle underlying the Regulator's price controls ... is to determine the level of prices that would enable Openreach to pass on its efficiently incurred costs and generate a return; and (ii) in the absence of evidence that any alleged Overcharge would have been subject to a rounding error, I consider it more reasonable to conclude by reference to the effect of any ... Overcharge on the unrounded value of X, than ... speculating on the effect of any rounding ... in the Counterfactual Scenario ..."

Then you say:

"If Openreach had not incurred any alleged Overcharge, the unrounded values of X would have reflected a lower cost base and hence Openreach's price[s] would have been lower."

So at this stage, Mr Bezant, you are really just assuming that this tiny increment, this tiny increment of overcharge would have actually led to a higher value of X, are you not?

A. I am assuming that a lower total cost base would have affected the revenues they needed to recover via lower prices.

Q. Via lower prices, in other words, in this context a lower X?

A. Yes.
Q. That is the assumption you are making here, is it not?
A. Yes.
Q. Would you agree that is completely unwarranted, given the inescapable fact that the X is calculated to either half a per cent or to one decimal point and we are dealing with minute quantities of overcharge?
A. We are dealing with a regulatory objective of recovering economically incurred costs, which is not -- which is an unrounded position in effect. So to the extent that costs overall are lower, the prices overall are lower through lower Xs. There is a rounding exercise within it, but its objective is to recover costs, and I have no reason to believe they were not trying to achieve that underlying objective.
Q. There is a clear theme in both your evidence and my questioning as to whether or not really, in the real world, this very small sum is enough to achieve that. You say it is, and I am putting to you it is unrealistic.
A. Well, I have explained how I think the systems work for different products, how that flows through, and whether that may or may not have an effect.
Q. All your focus is on process, without, in my respectful submission -- or rather without, as I put to you, taking

any account of how small this really is?
A. Well, I have taken account of the size of the overcharge claimed by thinking through how it might affect the models and the consequence of that within the different pricing structures deployed or regulatory structures deployed, and their objectives and their mechanisms.
Q. Well, let us talk now about the argument that developed in the subsequent reports, which is about the cumulative probability of this happening.
So the argument is, if I understand it, that the tiny amount of overcharge might be relevant to which step an RPI X factor is on. That might be unlikely in one particular case, but you can take a kind of cumulative probability approach to looking at the RPI X controls as a whole. Is that fair? Sorry, I have put that -- I have not been entirely clear.
A. I understand what you are trying to say and, yes --
Q. Yes.
A. -- you can look across --
Q. You can look across --
A. You can look across the piece.
Q. Thank you.
Now, the idea is, I think that, at some point, as a matter of probability, BT is going to hit the jackpot effectively as a result of the overcharge.

A. Well, it is not hitting the jackpot. It is the costs triggering a response that the model is designed to respond to.
Q. So let me break it down slightly. The idea is that the tiny increment of costs, which is attributable to the overcharge, will actually trigger a rounding-up. This is in the factual now, not the counterfactual.
A. Yes, a different set of costs will take you through a rounding threshold in some of the models.
Q. This could be -- that little bit of overcharge could be the tipping point, that is the essence --
A. Within a given model, yes, it could.
Q. Yes.
The rounding-up effect that that will generate will be bigger than the overcharge on the products in that charge control because it would take you to this step?
A. It would in that particular product, and in other products, if it had not triggered, there would be no reaction.
Q. Yes.
A. So that is why you look at it kind of in the round.
Q. So the effect would be to allow BT some extra funds, as it were, over and above the efficient cost of that product?
A. In the way that that model works, it -- well, you might

argue it does not give you enough funds until you get to that point; right? It cuts both ways. So it is just the way the model is implemented.

Q. But the idea, I think, in this argument is that those additional funds would constitute pass-on more generally, so you would be recovering the overcharge, but you would also be getting this additional fund because you are on this next step?

A. Well, it is not unique to the overcharge, it is the way they think about recovering all of the costs, including truck costs, including any overcharge within truck costs. It is just a model design --

Q. Yes.

A. -- so it does not -- it is not about overcharge, it is just about the way they think about cost recovery across the suite of products, subject to this glidepath form of regulation.

MR RIDYARD: Mr Bezant, would it be a fair way to put your approach -- your approach is a bit -- in a way a bit of an act of faith, as it were, but it is based on what you understand about the process, but the approach you have taken, you sort of -- you know your approach is going to be wrong 19 times out of 20, or 99 times out of 100, but on the one occasion that it is right, because it does trigger the thing, the size of the revenue gain, you know, the jackpot effect -- I know you do not like that term, but it seems in a way quite appropriate -- makes up for being wrong in almost all cases?

A. So if the objective is to recover ten and you recover the ten in one model and not in nine, because of the way the allocations of the ten fall, and the trigger happens, then you get your ten.

MR RIDYARD: Yes. So if you buy enough lottery tickets, you will win sooner or later?

A. Well, it is not a lottery in that sense, because the thing is structured to recover the overall cost base of the business which is being allocated into the products. There is an outcome that is a desired outcome here. The modelling involving rounding, to a certain extent, as you move through different products, there are some products that have got a slight under-recovery of their total costs and there are some that, arguably, have got a slight over-recovery of their total costs. That is the way the model works. It is not an overcharge issue; it is the model construction. But overall, you get your costs back, in the round. As I said, the ten, my example, is in this product and it is not in the other nine, but the bulk of the costs obviously are in the underlying products, it is just gradations as you move through time.

MR WARD: But the idea, is it not, is that -- forgive me, I am going to keep using the word "jackpot" -- the jackpot can then be, as it were, spread around other products for which the step was not triggered? Is that not the basis of it?

A. If you are saying, to use Mr Ridyard's example, the ten is concentrated -- or my example, the ten is concentrated in one product and not others, then you are saying it is --

Q. Well, it is what you are saying really, I am trying to understand.

A. No, I am trying to understand what your question was. But my point is that this is the design of the regulation that was in place. This is the design of the regulation that would have been in place for all costs, it does not matter whether they are a truck cost, a fleet cost, a labour cost, they are all costs, and this is the way in which the cost recovery was designed. In some cases, as you move through the process, as costs change, some products get a price increase, some products do not.

Q. Your argument is, I think, that you can take the benefit of this rounding-up that occurs in one product and essentially allocate that as pass-on in respect of other products where the next step threshold for the RPI X was

not reached; is that not right?
A. So, as a matter of the economic outcome, back to my example, if we had taken ten and we put one into each of the products by way of pass-on, we would have had pass-on of ten. If, using each of these models with these thresholds, you have pass-on concentrated in one product, ten, and zero in nine, you have pass-on of ten. So in both constructs you have the same economic effect. Whether one is legitimate as a matter of law, I cannot tell you, but as a matter of economic outcome, you are indifferent, because you have got ten passed on in both cases. I think Mr Harvey and I agreed that pass-on could take different forms. Again, we are not suggesting, legally, what the right answer is, but it can take different forms.
Q. You would accept, would you not, that there is nothing to suggest that Ofcom was actually trying to bring about a result where pass-on in one charge control could be achieved through a higher RPI X in another charge control?
A. Well, they are thinking about cost recovery overall and they are thinking about it across different products, and they decided to deploy this rounding mechanism. That is the mechanism that would have been in place.
Q. Well, let us look at your report, this is tab 9 for you

and it is {E/26} for us. Page 149 {E/26/149}, where you quote from Ofcom's six principles of cost recovery. The first one is cost causation:

"Costs should be recovered from those whose actions cause the cost to be incurred ..."

The third one is:

"Distribution of benefits ... 'costs should be recovered from the beneficiaries'."

So there is no part of Ofcom's view of the world that one should, as it were, spread the costs and benefits outside a charge control that governs a particular product, is it?

A. Well, I cannot speak for Ofcom, but they have designed a whole series of price control mechanisms and frameworks by reference to these core principles, so they must be comfortable that the overall result is consistent with these principles.

Q. It is not intending any jackpot to be spread widely across other products, is it? That is the point.

A. Well, it does not obviously refer to the word "jackpot", it refers to principles relating to the recovery of causally incurred costs and efficiencies and being confident that the mechanism for cost recovery does not undermine or weaken effective competition. So they have thought about all of these things in designing the

structure that we are dealing with.
Q. Obviously we have seen that a great deal of work is done on the detailed allocation of costs to particular individual products, have we not?
A. Very much so, yes.
Q. So it is really no part of their plan that there should be some larger distribution across products, is it?
A. Well, I have described to you how the mechanism works. I am assuming that they are comfortable that the mechanism is consistent with the principles of regulation that they are describing here.
Q. The next thing is we, of course, do not generally know what the unrounded value of X was in any particular case, do we?
A. No, because we do not have the specific final models or all of the models.
Q. Indeed, we have just been looking at how difficult it is to even establish how much overcharge there is in any particular price control; would you accept that?
A. Overall -- well, to the extent one has the cost allocations, one would -- and one could flow them through for trucks, then one would know, but we do not have that detail either, not provided.
Q. Exactly.
Even if we did know that, we would not know how

close the charge control was to the rounding step, would we?

A. No. Well, hang on, if we had the detail we would know precisely.

Q. If we had the detail, but we have not --

A. If we had the models we would not be having this debate because we would know precisely.

Q. Here, what we are looking at is a roughly 25-year time period, are we not? We are going back to 1997 to 2022 when we look at the pass-on argument?

A. The overall effect can last for approximately that period, yes.

Q. There are many different RPI X price controls or many different products through there, are there not?

A. Yes, there are.

Q. Some have been introduced in the course of that period, like LLU, and other products have become obsolete over time, have they not?

A. Yes, they will have done.

Q. What you are saying is that you can look across time and across products in order to decide whether there has been pass-on overall, is it not?

A. I think one of the things that informs you -- we are back to the discussion we had yesterday -- is one's performance over periods of time in recovering all of your costs and all of your changes in costs, because essentially, over the long haul, you are recovering through your changing prices all of your changes in costs.

Q. Is the argument that even if -- so even if BT hit the rounding-up jackpot, say, in 2015, for one charge control, you would say that could be treated as effective pass-on for other products at an earlier stage?

A. I am not sure I am saying that. We are obviously dealing with limited information, so I have explained, when you go through the different pieces of BT and the different pricing mechanisms, how I have thought about the question, but you do have to answer it at a certain level approximately because of the available information.

Q. So, again, if BT had hit the jackpot early on, supposing it had actually got lucky in 1999, you would be saying that this -- I know you do not like the word "jackpot", but this sum of money could be applied as pass-on for trucks bought in the future or price controls set in the future?

A. No, I am saying that, to the extent you have -- well, the way the truck costs pass through the system varies through time. It builds up and then it falls off because you have the end of the infringement and then depreciation, so there is not a constant overcharge through the system. I understand that. So, again, in some cases, the way it works, you would overstate overcharge by picking things at certain periods; in some cases you would understate overcharge and pass on. So, again, you have to make some sensible assumptions across the piece.

Q. Would you accept that if the rounded value of X in a particular charge control is affected by the overcharge, it is going to make a big difference which one it was, in terms of the size?

A. In the individual models, yes.

Q. Just to make that point good, if we look at your tab 14, please, the joint experts' statement, {E/84/39}, you can see that Mr Harvey has thought about this, and he says -- do you have that, Mr Bezant?

A. I do, thank you.

Q. Lovely.

"I estimate that the largest revenue difference if the overcharge were to have affected the rounded value of X, in any of the 29 instances where I have data available, would be approximately [£2.1 million] ...

"At the other end, I estimate the smallest revenue difference if the overcharge were to have affected ...

would be only [£49,000] of additional revenue for Openreach over the course of the ... period."

Then he had to update this thinking because you added a load of additional things you call glide paths in the annex to this very document, which we will come to in a minute, but he says -- and these are ancillary services. If we skim down towards the bottom, the last four lines of this paragraph:

"If the additional ancillary services are included, the minimum becomes £100."

So it is right, is it not -- and you have not responded to those figures in the joint expert statement to dispute them. But it is right, is it not then, it is going to matter a very great deal which product this rounding-up occurs on, is it not?

A. It does matter which product. As you know and as we have discussed, we do not have the models to identify that.

Q. Yes.

A. So the effect can be small and the effect can be large. On average, overall the effect is -- back to my example -- the 10, so there are 9 losers and one winner; you get your 10. We do not know what the losers are, we do not know what the winner is, but on average, across the models, you get your 10.

THE CHAIRMAN: Just so I understand this. You are saying that, in the 10, you recover the overcharge because of the effect on the rounding?
A. Yes.
THE CHAIRMAN: But you recover more than the overcharge for that particular product?
A. Yes.
THE CHAIRMAN: You can use the surplus, if I can put it that way, to cover the overcharge on the other products?
A. Well, you have not recovered it on the other 9, in your give an example --
THE CHAIRMAN: Right.
A. -- or any -- it is not just that overcharge, it is the costs more generally. So the 10, in the way the rounding works, manifests itself in one product, but not all of them. The question whether you can think of that as different to it being recovered equally across all products, I do not think of it as being economically different, because you have got 10 or you have got 1, instead of 10, you have got 10 sets of 1, it is still 10, and they are in different products.
THE CHAIRMAN: That -- you conclude from that that there has been a pass-through -- pass-on of the overcharge?
A. Yes. If, probabilistically, the overcharge is large enough to trigger one of the models flipping, and on

balance the consequence of that is you will get the overcharge back.

MR WARD: That is indeed the argument, and you will not be surprised to hear, sir, we will be making legal submissions about that in due course. But, in summary -- sorry, sir.

SIR IAIN MCMILLAN: No, just very quickly, just to aid my own understanding, I think earlier on, Mr Ward, you used the expression "lucky to hit the jackpot".

Mr Bezant, can I just ask you, is it luck or is this rule of 9 and 10 statistically inevitable?

A. So, the more models you have, the more statistically likely you will get to the average outcome. It is a bit like tossing a coin once, it might not come up heads, but if you toss it 100 times, you are very likely to have something close to 50 heads. So the more times that you repeat the exercise of allocating through these models, the more you are likely to get the average effect. In other words, not the jackpot, or not missing, but the overall result of getting your 10 back. So there is statistics underlying this, there is probability underlying this.

That is not unsurprising, because the regulator is trying to give you your costs back. He is not trying to have you miss and he is not trying to have you

over-recover; he is trying, over the piece, to get your costs back, and you achieve that over a series of models, over time.
SIR IAIN MCMILLAN: I see, thank you.
MR WARD: But it is not guaranteed to be 10 though, is it, Mr Bezant? That is what we have talking about --
A. No, it is not guaranteed, I agree.
Q. -- is it might be pennies.
A. It is not guaranteed, but, as I have said, over a broader set of models, you end up gravitating towards the average outcome or the expected outcome.
Q. Gravitating towards it, but what we have here is really just a theory about what might have happened as a matter of probability rather than knowing what actually did happen, is it not?
A. Well, we do not have the models. I think I have said that a large number of times --
Q. Yes, you have indeed.
A. -- and in the absence of the models, one has to answer a question: would there have been a pass-on, and, if so, what would the effect have been? I have tried to answer both of those questions.
Q. This -- what you are calling pass-through here is really just an accidental cross-subsidy, across products and time, if it happened at all?

A. I do not think of it as a cross-subsidy. It is just part of the way the regulation was designed. All costs are being treated equally in this way. All of them. The truck costs, labour costs, all costs, if the trigger takes an increase into one product and not into another, so there is no -- so that is just the way the regulatory regime was constructed, that is how it would have applied. The question is, would a different set of costs have led to a different set of outcomes?

Q. Now, it also matters, does it not, how many glide paths there actually are here? You initially referred to 40 in your first report. Mr Harvey has identified 29 for which he had cost data. But if we turn now to -- in the same document, to page 61 {E/84/61}, in the joint expert statement for the first time, you added in rather a lot of further glidepaths. We can see them here on page 61. What we can see, two things are obvious very quickly. We can see from the very first line that a lot of these are rather late in the day. So the first one you mention is 2015/2016. But then, six lines down, we have some from 2020 to 2021. So a lot of these are very late, are they not, into the period?

A. Well, they are a function of the information provided by BT if --

Q. Sorry, I do not mean late as in the day you produced

this. I mean late in when they actually happened --
A. No, I did not mean that either. I mean they are a function of what is available in terms of temporally which periods they cover.
Q. What most of these are are the so-called ancillary services, so tie cables and new provides, which is obviously a connection, are they not?
A. Sorry, say the last piece again. I do not quite --
Q. Connection, the new provide is a form of connection. So they are not the main product, like the MPF that we were talking about or --
A. No, but they are illustrative of the deployment of this type of pricing mechanism.
Q. They are -- some of them are of very low value indeed, are they not, which is why Mr Harvey has been able to say they might be as little as £100?
A. But I think they are symptomatic of the large body of models that it should exist generally.
Q. You have also seen that Mr Harvey makes the point that these are not really separate glidepaths, they are just part of the same price-setting exercise as main products, and you have actually separated different years of a single model into separate glide paths, have you not?
A. Yes, I have, because they can affect the trigger within

a particular year, but they are examples of the portfolio of glidepath path models that would have been in place and deployed and reacting to changes in costs.
Q. So the critical point here though is that, even if it is legitimate to treat these as individual glidepaths, they may have little or no material impact on the amount of overcharge recovered; would you agree with that?
A. These ones may not, but, as I keep saying, the more models you have, the more probabilistically one gets back to the average outcome being the likely outcome.
Q. Let us talk now about expected value, which is --
THE CHAIRMAN: Are you moving to a new topic?
MR WARD: It relates to this, but it is a new sub-topic. I am quite happy to stop now.
THE CHAIRMAN: Whenever it convenient to have our break, you work it out.
MR WARD: Perhaps I will do this, and then --
THE CHAIRMAN: Yes, sure.
MR WARD: I do not think it should take more than five minutes.
THE CHAIRMAN: All right, yes.
MR WARD: Famous last words, but that is my belief.
I was going to talk to you about expected value, which plays a role in your analysis here.
A. Yes.

Q. For this, we can go to tab 11 in your bundle and for us it is {E/43/31}. You say, at 3.34 -- I am going to try to avoid maths for the purpose of this discussion, I should say, we will see how I get on. You say, at 3.34:

"As the number of calculations ... increases, the average level of Supply Pass-on across all of the calculations will tend towards the expected value of Supply Pass-on."

You say:

"This is akin to a theorem in probability theory [known] as the law of large numbers."

What I want to do is just get clear in our minds what "expected value" means, and that is on page 29, please. You have a footnote where you explain it {E/43/29}. You say:

"The 'expected value' of a variable is its predicted value, calculated as the sum of all possible values each multiplied by the probability of its occurrence. For example, a lottery ticket with a 10% probability of winning £10 and a 90% probability of losing would have an expected value of £1 ..."

Then, you say:

"Focusing on the 90% downside fails to consider the value of achieving the 10% upside."

Now, this expected value is not necessarily the actual outcome that is realised, is it?

A. No. No, it is not. But, as I have said, the more incidences you have through models of glidepath triggers happening or not happening, the more confidence you have that you will have that outcome, the average outcome.

Q. Well, or at least one of those outcomes, because, of course, where the models have such divergent implications, we have talked about ranging from £100 to £2 million, as I have already said, it is going to matter enormously which one it is that gets triggered?

A. It might, but the more models you have, the more confidence you have that will you would get the average outcome.

Q. If you had enough models over enough time, you would be confident that would happen?

A. Well, it depends on how many models you have.

Q. Yes.

A. But you would be more confident the more models you have.

Q. When we look now -- if we can turn on, please, to page 30 {E/43/30} -- back to page 30.

At 3.31, you say:

"... the expected value of Supply Pass-on is equal to the extent of the Overcharge ..."

You say here.

A. Yes.

Q. You are not saying on that basis: therefore you recover the overcharge, are you?

A. On that basis alone, no, and I have explained why I think that is the best available estimate.

Q. But would you accept that this proposition that you are stating here is really just stating a mathematical relationship between the components that go into the calculation of expected value? That it will equal the overcharge?

A. Well, it will equal the overcharge. That is how the rounding system -- the rounding system is set up to recover costs in this way. It is not about the overcharge, it is about the way the rounding system is set up. It is just an explanation of why you need to understand both the chance of a trigger happening and the result of the trigger happening.

Q. But the fact that the expected value itself equals the overcharge is just due to the mathematics of the way expected value is calculated, is it not? It does not tell us anything about what will happen in the real world?

A. It does not tell you what will actually happen, but, as I keep saying, in the absence of the models, you cannot

test that --
Q. No.
A. -- and in the absence of the models, you can make some sensible assumptions, mathematically, about what is a reasonable assumption or the best available assumption. In the absence of the models.
Q. Just bear with me a second, if you would. (Pause).
So just talking about expected value, would you accept that even if you had one glidepath with a 1% probability, that would still come out in terms of expected value as the level of the overcharge? Because it is just the mathematics of this.
A. Sorry, I do not know what your question means.
Q. Let me unpack it a little bit. I am trying to get to the idea that this idea that expected value equals the overcharge is just the maths of the way expected value itself is calculated.
Let me give it a try, putting it in words --
A. Right.
Q. -- and let us see how we get on. This is explained by Mr Harvey in his third report and he was not challenged on this so --
A. I do not think we disagree about the concept of the expected value equaling the overcharge or equaling a sum of money. I do not think we disagree on that. We

disagree about the confidence with which you could --
Q. Yes.
A. -- expect that, because we do not have the models.
MR WARD: I can accept that answer. The maths is not in dispute. The question is, how likely is it and whether it really matters anyway for the analysis?

So if that is a convenient moment, I would be happy to stop.
THE CHAIRMAN: All right. Well, consistent with yesterday, we will have a 15-minute break.
(11.30 am)

(A short break)

(11.47 am)
THE CHAIRMAN: Yes, Mr Ward.
MR WARD: Thank you. Can we go back, please, to the joint experts' statement which is your tab 14 and our E/84, {E/84/29}. This is the summary in G.1.4 of the different types of charge control which apply and I am going to try to deal pretty briefly with the remainder. We see under glidepath which is 55%:

"3% related to extensions to existing glidepath charge controls".

Here the point is really a short one. When that happens, would you accept that, generally, there is no consideration of any actual or forecast costs made for

the purpose of the extension?
A. Yes, I think that -- I would need to look but it is a small percentage of the total they have rolled forward to pre-existing arrangement.
Q. Yes, so we cannot conclude, can we, that the level of overcharge actually paid in that time period has caused the prices to be set higher?
A. Not within that time period but if you brought something forward that has been affected, then that would carry into the period.
Q. It would, it just would not actually reflect the levels of overcharge actually paid in that period?
A. If that was a relevant consideration on these products, no, it would not connect exactly.
Q. Let us talk now about the next category which is charge ceilings and fixed price caps. These are prices where there is no RPI minus X mechanism, there is just a maximum -- usually a maximum price set by the regulator?
A. By reference to expected efficient costs, yes.
Q. Yes, indeed. I just want to show you one example which -- partly really to show the tribunal that not everything is quite as well developed as the LLU example we looked at. This is in your bundle at tab 35; for us it is {I4/89}. This is "Wholesale Line Rental", so that

is the other element of BT -- Openreach that we talked about earlier. This statement is from 2006. If we look at page 3 {I4/89/3}, we can see what it is about. It says:

"Wholesale Line Rental ... allows alternative suppliers to rent access lines on wholesale terms from BT, and resell the lines to [consumers] ..."

Then it notes at paragraph 1.6 towards the bottom of the page:

"The charges for WLR have not been reviewed since the starting charges were set by the DGT ..."

Which is the Director General of Telecommunications, in other words Oftel.

"... in June 2002. At that time, the rental charges ... were set at £28 per line per quarter ... and £29.87 per line per quarter ..."

With an RPI of minus 2. So that is, by this time, quite a few years old, is it not?
A. Yes.
Q. We see over the page that -- at 1.9, we can see BT in fact had been reducing its prices below the permitted level at that time.

Then this is really just a summary but I think it will suffice for present purposes, at 1.12, Ofcom summarises its approach which is to say it uses -- in the first bullet:

"Used cost data for 2004/05 from BT's audited regulatory financial statements ..."

Then I just invite you to skim the bullet points, it makes various adjustments which it summarises in short form. (Pause)

A. I have read those, thank you.

Q. Of course it may be that in that cost base somewhere is trucks, as we know, as Mr Harvey has shown, that trucks were likely allocated to WLR products but they are not identified specifically either here or indeed anywhere else in this document.

A. They are not identified in this document. If this product uses trucks, there will be a cost allowance for trucks within the analysis.

Q. If we look at the prices that we can see under 1.14 on page 5 {I4/89/5}, we can see prices rounded to the nearest pound except for one of those prices. So residential WLR, new line installation, £88, transfer charge £2 and then with some pence, £100.68 for the line rental charge ceiling. Business WLR is £88, £2 per line and £110 per year.

Just one further thing before we leave this document, if we turn to page 16 {I4/89/16}, you will see at the bottom of the page, 3.27:

"Ofcom has considered both forecasting costs beyond 2005/06 and setting a charge control. However, Ofcom considers that present costs are not sufficiently stable to forecast costs beyond 2005/06 or for a charge control to be imposed ... Further, where a charge is below the charge ceiling, BT is able to set a cost oriented price ..."

So it has some flexibility. That is why it says it in fact -- sorry. I am just going to leave that point because I realise there is some misinterpretation on my part, so sorry to have troubled you with that paragraph unnecessarily.

The point I wanted to make about this we can see if we keep in mind those prices but now turn back to Mr Harvey's first report, which is your tab 8. This is {E/7/111}. We looked at this earlier in fact I think.

Do you have that, Mr Bezant?

A. Sorry, excuse me?

THE CHAIRMAN: He was just asking if you had it.

A. Sorry, there are a few bundles, yes, I do. Apologies, yes, I do.

MR WARD: At paragraph 6.70 is the figure that Mr Harvey generated, albeit for the years 2007/2008 so it is a couple of years later. But at that time he says:

"Taking the estimated impact of the overcharge on

WLR rentals costs [130-odd thousand] alongside the total costs [2 billion-odd] implies that the overcharge accounted for 0.006% of total WLR rentals costs ..."

That is not for exactly the same year that we are concerned with here but it does give us a sense of scale. Really all I want to put to you, Mr Bezant, is that it is just inconceivable that overcharge of this kind of level could make a difference to the sort of price setting we are seeing here in these charge ceilings for WLR. Even if the trucks are in there somewhere, it is just too little to matter.

A. So to the extent -- there is quite a few costs in here, there is quite a few references to costs. You pointed I think to a table where certain costs had been rounded. Yes, there may be moments, if there is rounding, where it will not have an effect. I agree with that.

Q. Okay. Let us move on to another topic. I want to try -- in fact still within the topic of caps, I am going to just give you an opportunity to comment on some of Mr Nicholson's evidence where he generalises about different types of cap. If I had time, if I had the luxury, I would take you to the underlying documents. I do not. If you tell me you do not feel able to comment, I will of course accept that.

We can see this in tab 17 for you; {D/11/12}.

A. Let me put some bundles away.
Q. Of course, please.
A. Right, thank you.
Q. What Mr Nicholson does here is describe various types of caps, price caps that Ofcom imposes and I just want to at least put this to you and see if you are able to agree or indeed disagree. He says at 4.12, if you have that:
"Ofcom has taken broadly four approaches to setting the level of a 'price cap'."
The first one is "RPI-X" which we obviously do not need to discuss anymore. Then 14.12.2 is the so-called -- he calls it a "determined price cap approach". He says:
"This approach is typically taken where a service is nascent and future costs are uncertain, eg the level of demand is very uncertain ... A specific ... price cap is set based on Ofcom's assessment of Openreach's efficient costs.... "
So I think that, probably, what we have just been looking at is an example of that.
A. Yes, for newer products generally.
Q. He observes at the bottom of that paragraph:
"I observe from my experience with regard to determined price caps that the prices subject to the cap

stayed flat regardless of changes in the underlying cost base."

That is indeed the inexorable logic, is it not, of a price cap? It will just stay flat no matter what is happening in the real world.

A. Well, it stays in place for the period in which it is in place. If it is not in place for very long, because you are waiting to see how costs develop, then it will be in place for however long it is in place. It is a truism.

Q. Then he talks about two other types of cap, let us look at what he says:

"The 'safeguard cap' approach. This approach is typically taken where a service is nearing end of life and a newer technology substitute is entering the market. The cap protects the current customers whilst encouraging innovation and incentivising migration ... Ofcom simply requires the price for a product or tariff basket over the price control period to stay flat in nominal or real terms."

He gives an example of ISDN30.

"Where Ofcom sets a safeguard cap, it typically did so without reference to costs as its primary concern is not cost recovery per se but rather consumer protection and innovation."

Are you able to comment on that? I am sorry to be

putting this at such a general level.
A. That is all right. So he is describing what happens. He also explains that this type of cap was the exception during the period, by which I understand it was not deployed very often.
Q. But are you able to say whether you accept what he is saying here in terms of the general description of how it works?
A. Well, if the price has been set, then it has been set.
Q. Then the anchor pricing approach which is the last one he mentions. He says it:
"... has been adopted at times of technology change -- eg during the move from CGA to NGA ..."
"CGA", I cannot remember what it stands for but "NGA" is next generation. Perhaps you know, Mr Bezant? Something "generation access". "Current"?
A. I cannot remember the precise acronym.
Q. I am going to pitch for "current".
A. Okay.
MR BEARD: "NGA" is definitely new generation.
MR WARD: Yes. Probably it is about going from copper to fibre.
"This means that price caps set by Ofcom may not immediately reflect the forecast efficient costs of a new technology but, for a time, may be based on the

costs of the existing technology. For example in the [fixed access market review] ... 'for at least this market review period we consider that anchor pricing based on a hypothetical ongoing copper network and pricing flexible for VULA [which is a new generation product] gives the best balance ...' Again, a key observation ... is that the anchor pricing ... was not based on Openreach's incurred costs for the price controlled services."

Does that match your understanding?

A. Yes, it is still based on costs but they are using one set of technology costs as opposed to another for the purpose.

Q. Exactly.

A. But it is still based on costs.

Q. So would you accept that these kind of caps make the link between the overcharge even less clear than the kind of detailed modelling that we looked at this morning?

A. The safeguard cap does to some extent. Again, it depends upon how that price was set in the first place, obviously, and what leads that to carry forward.

The anchor pricing, again, I think they would use whatever costs they had and in the counterfactual they would use whatever costs they had. They are just

picking different cost bases for these purposes --
Q. Yes, for the different products.
A. For a different product but it still has a cost base and if the cost base is different, the cost base is different. But I agree there is some further step here in the way they are thinking about the pricing, but it is still informed by costs.
Q. You will not be surprised when I put it to you that what this means is it is even more unlikely that this very small amount of overcharge that we are debating would actually be recovered?
A. To the extent that the links with costs are being weakened in these approaches, I would -- costs generally, I would agree with you.
Q. Thank you.

Let us move on to the last of the Openreach type of cost controls which is cost orientation. I think we can mostly take this from the joint expert statement, your tab 14, and that is {E/84/50}. Here we see some language of yours that we talked about yesterday in fact, in other contexts.

"Mr Bezant considers that cost --"

Sorry, it is G.3.3.

"Mr Bezant considers that cost orientation obligations (ie the obligation to set cost-oriented prices) created a link between Openreach's costs and price. For example:

"Ofcom explains that a 'cost orientation obligation typically constrains the level of the charge by explicitly linking prices to cost' ..."

But then you explain in your next bullet point how that actually happens and you say:

"It is the evidence of Mr Nicholson that cost orientation obligations have been consistently interpreted by BT and Openreach as a requirement to price its products between the DLRIC (price floor) and DSAC (price ceiling) ..."

So you are recognising there that the cost orientation is interpreted to apply -- to allow a band of pricing between those two cost measures, are you not?

A. Yes.

Q. So would you accept then that, even if, as you put it, it creates a link between cost and prices, it certainly does not follow that the overcharge increment would entail that BT would pick a higher price within that band?

A. It depends upon where in the band they price by reference to the band and the extent to which the costs identify your lower band and your upper band. If they price, I think, close to the ceiling, which I think they did as a rule, then that would inform pricing decisions with a different cost structure.

Q. Let me show you what Mr Nicholson actually says about how they priced, which for you is tab 17, {D/11/28}. It is paragraph 6.3.3. What he says is:

"Where a product was subject to a 'Cost Orientation' obligation, the Pricing Board generally chose where to price within the DLRIC to DSAC range having regard to: (i) costs -- typically using the relationship to DSAC as a benchmark; (ii) current pricing of the relevant product or price expectation; (iii) customer willingness to pay; and (iv) any available estimates of price elasticity."

So there is a range of factors there, are there not, including the cost?

A. Yes.

Q. What I am putting to you is, one cannot conclude from that that the overcharge entailed a higher price in the context of products subject to cost orientation.

A. If the pricing -- well, as I say, there are other factors that may apply, I agree with that. If the price is influenced because you are pricing up to a particular cost cap, that is important to you, and if that cost cap changes, then your price can change.

Q. Well --

A. But if you are pricing by reference, maybe you have got a headroom, then -- and if your price changes, no reason to change your headroom -- your costs change, excuse me, and you are 10% below that ceiling, then it may change. But there are other factors, I agree with you.
Q. There is no evidence, is there, at all that the overcharge was critical in whether or not they were up against one of these cost thresholds, or indeed how they chose to price at all?
A. That is quite a generalised statement. I thought they tended to price to the caps that they faced.
Q. Well, that is not what Mr Nicholson is saying, is it? He is saying they priced within this range. In fact, there is evidence somewhere that often they priced outside this range, despite this obligation.

But what I am putting to you is there is nothing to suggest that this -- sorry to say it again -- this tiny amount of overcharge actually makes a difference to how they chose to price within that band?
A. It would depend upon how the overcharge affected the price bands and how they would have responded to that in a counterfactual world.
Q. Indeed it would, and that is not something you have been able to reach a firm conclusion on, is it?
A. No, I have focused primarily on the price controls that

cover about 85% of the revenues. This is a subset of the revenues.

Q. While we are here, I would like to just look now at what Mr Nicholson said about non-regulated products. Unfortunately this is in the confidential version only, so you will be able to see it, Mr Bezant, but can I just get instructions from behind about whether this can go up on the screen at least. (Pause).

It is fine to go on the screen and I will not read it out. It is {D/IC11/29}. Could I just invite you to read to yourself paragraph 6.3.6, Mr Bezant? (Pause).

A. I have read that, thank you.

Q. Thank you.

We can put that aside now and go back to the joint expert statement, but this time we do need the confidential version which quotes some of this material, but we will again read it without reading it out. So it is {E/IC84/52} and for you it is tab 14.

This deals with Openreach's unregulated products and you give a set of reasons for thinking again there is a connection between the costs and prices at least, and if we look at your three bullet points, the third one summarises Mr Nicholson's evidence:

"Whilst Openreach did not use a 'set formula' for determining all of its prices not subject to price controls ... [that] does not mean that the approach was a 'general' [quoting a word of Mr Harvey] ...

"The Pricing Board of Openreach based its pricing decisions on the financial analysis ... that is ... based on factors specific to the product ..."

Then:

"As summarised by Mr Nicholson ..."

For some reason this has a slightly different confidentiality marking, but, to be careful, I will not read any of it out, but it is the same paragraph you just looked at.

A. Yes.

Q. What I am going to put to you again is really the same point I have put many times: nothing here implies that the overcharge would give rise to some mechanical relationship between cost and price so that it would actually have pass-on?

A. I do not think I have said it is mechanical in the context of these products because of the considerations. I have said I think costs are a relevant consideration to the way prices are set against --

Q. But that gets us nowhere near to the conclusion that the result was prices were higher by this tiny overcharge increment, does it?

A. It may not in the context of these particular products.

Q. Well, or any product, I would suggest.
A. Well, we have discussed obviously the ones where it may affect them through the mechanisms -- the glidepath mechanisms.
Q. Well, we have dealt with those separately.
A. Yes. Yes.
Q. Let us talk very briefly now about BT's other lines of business, because I am running out of time and I want to just deal with this very quickly.

Firstly, BT Retail, and I think it is common ground that BT Retail matters insofar as it received inputs from Openreach and from BT Supply Chain?
A. Yes.
Q. Obviously there is a discussion about the extent to which Openreach passed the costs on in the first place.

But there is another scale point here, I am afraid, to go back to my, I am afraid, probably rather too persistent theme. Can we go back to Mr Harvey's first report? Again, it is tab 8, {E/7/251}. It is paragraph 10.15, where he is considering, if there is an assumption that Openreach did pass through to BT Retail, what would the financial implications be of this for BT Retail.

If we pick up around halfway through this paragraph, he says:

"BT Retail accounted for approximately 36% of Openreach's revenues ..."

This is 2010/11 as an example:

"Even assuming that Openreach increased its prices as a result of the overcharge, which I consider to be highly unlikely [but you of course disagree], assuming that the overcharge was passed on in proportion to BT Retail's share of Openreach's revenues, the depreciated overcharge when assessed on a per customer basis would be £0.0014 ..."

He is talking on a per customer basis because, of course, Retail essentially sells phone lines and phone services to people.

Would you accept that this kind of scale makes it highly unlikely, if not inconceivable, that the overcharge actually affected the prices that were set?

A. So, it is as before. BT Retail is drawing on Openreach for some of the products that it sells, as are third parties. Openreach is passing on the costs of those products.

Q. On your account.

A. Well, it is passing on its costs, whatever they are. It is passing them on to both BT Retail and third parties, such that the general market price -- these are both therefore variable costs for BT Retail and their

competitors, they make up I think a reasonable proportion of the costs of the service ultimately. So if costs are coming down the line from BT -- sorry, from Openreach, excuse me, then I would expect BT Retail to pass them on to their customers, because everybody in the market has faced an increase in their costs and therefore is likely to pass them on.
Q. Yes, to go back really to a point I made for the first time yesterday though, what we are really concerned with here is whether the particular bit of overcharge in fact caused the price to be higher, not the same thing as cost recovery overall. That is what is so unlikely here, is it not, Mr Bezant?
A. Well -- so to the extent that the costs incurred by BT Retail have increased and its competitors' have increased, because the costs have increased or decreased, whichever way round you are looking at it, then that base cost has changed, they will have an incentive to change their prices to their customers.
Q. But it just does not follow that the price they actually charge the customer is 0.0014p higher as a result of this, does it?
A. Well, it depends on obviously, of course, which products coming down the line the price changes for. It is not necessarily increasing uniformly.

Q. No, indeed, so in fact --
A. It depends on how it changes.
Q. That 0.0014 might be spread across a whole lot of products, like, for example, a line rental and call charges?
A. Which would be consistent with the glidepath, some of them triggering and some of them not. I agree.
THE CHAIRMAN: So is 0.14 of a pence?
MR RIDYARD: 0.14 of a penny, yes.
MR WARD: 0.14 of a penny.
THE CHAIRMAN: Right.
A. Across all customers, across all products, but it would have been concentrated in certain products, as we have discussed.
Q. Could have been. Could have been.
A. Well, to the extent a trigger had occurred, yes.
Q. That is going back to your RPI X probability lottery that we talked about earlier.
But putting that aside for a moment, I am just putting to you, it is just a diff -- it is an additional step you are unable to make to conclude that the price is actually 0.0014 higher because of this than it otherwise would have been?
A. We have virtually no information on BT Retail because of the way information was provided. I do not say that

critically. It was not --
Q. But the tribunal ordered it.
A. No, but it was not understood at the time, as I understood it, that BT Retail was relevant in terms of its use of products that included trucks. I think that position changed over time, so we had a pricing statement and I think that is all we have. We have a pricing statement on BT Retail; we do not have data.
Q. Obviously, proportionality played some role in this, even if we did end up at 2,000 pages of reports --
A. I am not -- I am just describing why we have little information --
Q. I understand.
A. -- to analyse BT Retail, because you are asking me questions that, if I need to give an analytical response, I do not have the data.
Q. In truth, the answer is you just cannot provide that answer?
A. Because I do not have the data.
Q. No.
Any more than you could on the non-regulated prices we were talking about a moment ago?
A. No, I am not sure that is quite the same thing, because I think the market structures are different.
Q. Well, it is the same thing, in the sense that one has to

look again for the conclusion that the actual prices were actually higher by the increment of the overcharge. That is the same point.

A. Well, the same question arises, yes, but the answer may differ depending upon the information available and the market context.

Q. Well, I have put my case on that.

Let us just look just very quickly in a bit more detail at BT Retail, because of the -- mostly because of a point that Mr Beard made yesterday to Mr Harvey.

The pricing statement itself, I am afraid this might not be the same reference Mr Beard gave, but you have it at tab 39 and we have it at {D/IC16}. That is what it says, I need to check that is right. Yes, it is, and --

A. Hang on a sec while I just make some space.

Q. I am going to go to page 17 {D/IC16/17}. In fact -- yes, that is fine.

THE EPE OPERATOR: There is some confidential information.

MR WARD: Yes, I am just wondering if we should put up the non-confidential version and see if can get away with that for this present purpose. It is {D/16/17} then.

Do you have it, Mr Bezant?

A. Yes, I do. Thank you.

Q. The confidential material, which we are not putting on the screen because I think this probably is sensitive, I hope you can agree, paragraphs 26 and 27 show that costs were a factor, and indeed --

THE CHAIRMAN: Which page are you on?

MR WARD: I am now on page -- the problem is I am going from the confidential version and I am not comfortable putting this up on the screen.

THE CHAIRMAN: No, that is fine.

MR WARD: So, let me try and put it to Mr Bezant and see if we can manage.

THE CHAIRMAN: Do you want us to look at the confidential one?

MR WARD: If it is convenient to, yes. Can that be done, without putting it on the screen?

THE CHAIRMAN: So what was the reference?

MR WARD: It is {D/IC16/15}. Page 15.

THE CHAIRMAN: Ms Paula Carter.

MR WARD: That is right. Her witness statement exhibits the pricing statement.

THE CHAIRMAN: Right.

Which paragraph?

MR WARD: Thank you, sir. It is paragraph 26. I just invite you, the tribunal and Mr Bezant, to read paragraphs 26 and 27. (Pause)

THE CHAIRMAN: You want 27 as well?

MR WARD: Yes, please. (Pause)

Thank you.

Mr Bezant, it is really just a short point. Costs were obviously relevant to prices, but so were many other factors, were they not?

A. Costs were relevant to prices, other factors were too, yes.

Q. So, again, one cannot conclude that the overcharge would have been passed through in terms of higher prices than in the counterfactual?

A. I think I have explained why I think, on balance, given the market structures, if they had affected the price -- if it had affected the costs coming in to BT Retail, then that would have affected the prices charged out by BT Retail. But I have very little information and I accept there are other factors.

Q. I have put my case on that point a number of times.

The point I wanted to pick up that Mr Beard made to Mr Harvey yesterday actually relates to paragraph 30, which is a summary of the regulation that applied to BT Retail between 1997 and 31 July 2006. This is not marked as confidential, so we now have that on the screen {D/16/17}. It is really just this: if I can just invite you to read that quickly and then I will just put my really one-sentence question to you.

A. All of paragraph 30, just to be clear?

Q. Yes.
A. Okay. (Pause).
I have read that, thank you.
Q. Thank you.
Just before -- really I have two questions. Firstly, would you accept that, as a general level, the Oftel modelling was a lot less sophisticated than the kind of Ofcom modelling we spent some time on earlier this morning?
A. It looks like it, yes, without going into the detail.
Q. When we look at these controls, we see RPI controls in pretty broad terms, so (a) is minus 7.5; (b) is minus 4.5 to the first 80% spend of residential customers; (c) is RPI minus 7; (d) is RPI-RPI applying to the lower 80% of residential customers; and then (e) simply says it was -- oh, and then -- sorry, and then there is RPI 0 running to July 2006, then it lapsed.
Would you accept that is nothing like granular enough to be affected by the overcharge, given, again, the sums that we are concerned with?
A. I agree with you it is not granular. There is a range of regulation applied to BT Retail, but this piece of the regulation is not granular.
Q. Then, finally, before we move on to loss of volume, I want to speak very briefly about BT Supply Chain and

Global. Mr Beard did not put any questions to Mr Harvey about this and I do not want to spend a lot of time on it. Let me see if I can do it in a very summary form.

We know that both of them took some account of margins and costs in their price setting?

A. Yes.

Q. We know that they both tendered on external bidding markets, did they not?

A. Yes, BT Supply Chain, of course, was predominantly an internal service provider.

Q. Yes.

A. There is a small nub that is an external service provider.

Q. What the evidence says is that they put in their bids and then they negotiated with the customers, you will recall?

A. And, without going into it, they had costing assumptions and margin assumptions as a part of that bid process.

Q. As a part of that process, absolutely.

I really just want to look at what you say about this in the joint expert statement, so back to tab 14, Mr Bezant, for you, and for us it is {E/84/58}.

A. Sorry, I missed the page reference.

Q. 58, please.

A. 58. Thank you.

Q. I am wondering if that is the wrong reference.
J.2, and this is actually, in fact, in respect of BT Global. You say, particularly the last half a dozen lines:
"In the Counterfactual Scenario, if the prices of [the Openreach] products were lower [the ones that feed into BT Global] ... [then] the prices calculated in the Business Cost Models would ... have been lower ... it [is] reasonable to conclude that [the] lower 'starting point', and following the same commercial negotiations as in the Actual Scenario (for example ... applying [a] discount ...), the final price would have been lower."
I really want to just put to you that this approach is just unduly mechanistic, which assumes that you have price-setting based on highly detailed cost modelling, and then commercial considerations are somehow going to be exactly the same, irrespective of -- the overcharge is somehow going to track through those commercial considerations so that you actually end up with a higher price, but that is just a -- that is what you are saying, is it not?
A. So, if your costs are different, when you come to think about your bids and your desired returns and your target pricing, then that will inform and affect your bid.

Q. But it is a huge assumption that the commercial overlay of this means that you will actually end up with a slightly different price because of this tiny piece of overcharge?

A. But, again, you are not starting from one price and then taking a bit of cost out and thinking, shall I change my price? You are starting with a different set of cost assumptions from which you are targeting a price. So you will have the same thought process, but if you have got a different cost base to start with, higher or lower, that will inform how you think about it in the counterfactual world. You are not comparing and contrasting with the actual world. You are working in a different world. Your costs are different. You may very well target a different price because it will give you the same margin.

Q. Well, that would be very plausible perhaps if we were talking about a significant cost element rather than one that is extraordinarily small.

A. As I said, if the costs -- and you build up all of your costs -- are different, then it may flow from there that your pricing is different.

Q. Well, I am putting to you again, just hopefully for the last time, it is just implausible to suggest that such small price increments would make a difference?

A. It is not about price increments, it is about the costing that you have in front of you when you make pricing decisions, and if they are slightly different, you start from a slightly different position.
Q. But the point I am making is it is so slightly different that the likelihood of you ending up in a different place is vanishingly small, but that is where we disagree.
A. I think we disagree to some extent, yes.
Q. Yes. With that, I would like to turn back to Royal Mail for the purpose of loss of volume, and I am sorry to, as it were, cycle back into the world we thought we had left yesterday, but it is thankfully a reasonably narrow point and I am now confident of finishing by lunch.
THE CHAIRMAN: Great.
MR WARD: Now, you will be aware, I am sure, that Professor Neven has given evidence on the loss of volume claim relying on your work.
A. Yes.
Q. I am talking to you about it because DAF's solicitors essentially invited us to do so. The issue arises on the assumption that the overcharge was passed on through supply pass-on and part of Royal Mail's response to that -- obviously it does not accept that in the first instance but, if you are right, it says, well, if it was

passed on, then it claims lost volumes arising, essentially because of its modelled elasticity of demands for postal products. You are nodding. If you do not mind saying "Yes" for the transcript.

A. Yes, I understand what you are saying, yes.

Q. Okay. But this is all familiar to you, I hope?

A. Reasonably, yes.

Q. Good, okay. I do not want to catch a cold with it.

The issue that I am taking up with you is whether the prices set would have been increased, would be higher, essentially to compensate for the lost volumes arising from the overcharge. That is the issue.

What Professor Neven says is there would have been higher prices on what he calls the inframarginal sales, in other words the sales that have not been lost through loss of volume. Are you familiar with this argument?

A. I have not studied Professor Neven's report.

Q. No. Well, perhaps you can take this from me. Obviously we have a difficulty here in that we were planning to ask Professor Neven about this but we do not want to be told later in closing that we somehow failed to explore our case with the right witness, so that is why I am taking you through this.

But the argument is that the retained sales achieved a higher price because the lost volume will have led to

the price being calculated higher to compensate for that lost volume. That is Professor Neven's argument, as I understand it.
A. Sorry, let me see if I understand this. There has been a pass-on. It has caused a loss of volume because of the interaction between prices and demand.
Q. Yes.
A. What has then happened?
Q. The prices are set a bit higher to compensate Royal Mail for the fact it has indeed lost some volume, so it is somehow recouped on the remaining sales. That is the hypothesis that Professor Neven is advancing.
A. Right.
THE CHAIRMAN: Sorry, so I understand, prices go up because of the overcharge which is passed on?
MR WARD: Yes.
THE CHAIRMAN: They go up again because of the loss of volume.
MR WARD: Yes, that is the argument. Mr Beard will pop up, I am sure, in his usual way if he thinks I am misrepresenting it, but so far that is I believe what Professor Neven is arguing, and we might ask him about that to make sure we understand it.
That proposition itself, is that something you can help with or comment upon?

A. It is not something I can help with as a matter of economics of the interaction of the product set and volumes and prices in the way that Professor Neven and Mr Harvey have been discussing them.
Q. Well, that creates a little difficulty for me, I must admit, as I am being told to put this to you.
THE CHAIRMAN: Sorry, how can the prices go up above the price caps?
MR WARD: I think the argument is -- and this is why we would be better discussing this with Professor Neven -- I think his argument is that when the price caps are calculated, then one would factor in the volumes and basing the prices on the increased cost because of the overcharge, you would understand that volumes were a bit lower and, therefore, prices would be set that little bit higher to allow you to recover, because of --
THE CHAIRMAN: So it is something that Ofcom would have taken into account or Postcomm?
MR WARD: Postcomm. I think that is his argument.
THE CHAIRMAN: That is probably a question for Mr Bezant if that was something --
MR WARD: Well, that is why --
A. Okay, so now I understand the context, thank you.
Q. Okay, no, that is fine.
A. So if I think what this question is directed to is that,

in thinking about the regulatory regime that it would allow, Postcomm, is Postcomm aware of the interaction between prices and volumes and the demand being affected by the price, and therefore to the extent that it is awarding a set of revenues, it is doing so in the context of the volumes that it expects but where the volumes and the prices are connected. So it takes both volume effects and price effects into account in arriving at a set of allowed revenues to cover a set of costs. It is a systemic approach. That is what it does. Is that the question you are asking me?
Q. That is definitely -- we are heading in the right direction.
A. Okay.
Q. The question is really whether these volume effects would be picked up, if you like, through regulation in the way that Professor Neven is contending?
A. Well, we are somewhat on the boundary here, but I would expect in principle the regulator and Royal Mail for that matter to appreciate the interaction between volumes, prices and costs when thinking about the composite outcome for a regulatory period. So to the extent prices were higher because costs were higher, which had an effect on volume, and then it has an effect on cost and you have to come back and think about what

revenues you need to cover all of that, they would understand that linkage.
Q. Okay.
A. How they would affect it is a separate question but they would understand the linkage and take it into account.
Q. It is a separate question, indeed, as you say. I want to start by showing you -- I am afraid this is not in your bundle because this has all been a bit last minute, I am afraid. It is bundle {E/1/185} and this is Mr Harvey's report on loss of volume, so you would not have seen this I do not think.
A. I think I have seen it but I am not sure I --
Q. I am sorry, it is in your bundle, I am told, it is number 27.
A. All right.
Q. My mistake.
A. I have that, thank you.
Q. Mr Harvey has done a set of calculations here. You will see at the top of the page, "Percentage price increases consistent with 50% pass-on scenario". I am so sorry, you are still looking. 185.
A. Yes, thank you.
Q. You will see at the top of the page, "Percentage price increases consistent with 50% pass-on scenario" because what he did was test various pass-on scenarios. Then he

looks at the overcharge --
A. I thought he tested for a single pass-on.
Q. Yes, in this table --
A. Yes, so in this table, okay.
Q. Yes, sorry. You will see he has got the overcharge, he has got the amount passed on at 50%, and then he has got the change in volumes that that implies and the change in prices that the overcharge implies.
What we can see is that the change in volumes implied are extremely small. In fact it rounds to zero in some years and minus 0.01% in other years. Do you see that?
A. But, again, we are not dealing with changes in prices from a position we start at, we are dealing with a counterfactual in which you have a different set of costs --
Q. Absolutely.
A. -- implying a different set of prices and they think about the implications, elasticity and so on, so they just arrive at a systemic response, volume, costs and prices that allow for a set of revenues to cover the costs.
Q. The critical question in this litigation is, of course, about whether that change in volumes is in fact going to trigger a change in prices to compensate?

A. In the loss of volume?
Q. Yes.
A. Yes.
Q. So the first step in this is we need pass-on to actually happen, and that is what we have been discussing for the last day and, of course, as I said yesterday, we do not accept that it is at all likely in the Postcomm era because of the tiny scale of the pass-on again. But, if that did happen, so if you are right and it did happen, then it triggers this change in volumes and the question is whether that tiny change in volumes is actually reflected in an even tinier further upwards tick to prices. So you have got the pass-through, which is already contested, but beyond that there has got to be a yet further very small change in prices to reflect this very small change in volumes. That is the hypothesis we are testing, is it not?
A. Right, but that is consistent with the fact that if your volumes fall, then you have to recover your costs over a smaller volume of products. It means your prices have to rise to achieve that.
Q. The question is whether there is any reason to think that the price setting is sensitive enough to pick up these tiny, tiny changes in prices that would be implied here.

A. Well, I can tell you that the regulator is trying to match cost and revenues, back to that proposition, trying to match cost and profits to revenues, doing so with detailed models, understanding the interactions between volumes and prices and costs, so I can tell you they understood all of that and would have taken it into account, it seems to me, in arriving at the regulatory regime they have in the actual world and the counterfactual world. How they would have implemented it is not a question I can answer.
Q. No. Let me put the point to you that there is -- we had enough of a debate yesterday about whether the overcharge itself is big enough to actually shift the dial on a price control that is 3% initial uplift and then an RPI X, down to one decimal point. I am going to put to you it is just inconceivable that these tiny volume changes could actually have an effect on a price control characterised in those terms.
A. Well, again, I do not think so because if the regulator is trying to achieve a matching and has to understand that if your volumes fall, you need your prices to rise to cover your costs, then in principle it will react. In practice I cannot tell you because I do not know what they would have done with their models.
Q. That is indeed the case. Can we put that aside and look

at your first Royal Mail report, which is your tab 2.2? This is {E/25}, please.
A. Sorry, which?
Q. Your tab 2.2.
A. Oh, thank you. I have got that, thank you.
Q. You have got it?
A. Yes, thank you.
Q. Super, thank you.
Can we go to page 123 {E/25/123}? This is where you are commenting on volume effects in the PC3 period. At 14.58 you say:
"The extent to which Postcomm accounted for anticipated volume effects in determining the price caps depends on whether, and the extent to which, Postcomm adjusted the mail volumes for different price caps. It is not possible to know with certainty how Postcomm acts as: (i) I do not have information on Postcomm's internal decision-making processes ... and (ii) it might depend on the size of price changes and volume effects."
Then you say at 14.59:
"... published documents in respect of the PC3 review ... suggest that Postcomm might have accounted for the relationship between prices, volumes and costs."
What I am putting to you, Mr Bezant, is that nothing here can possibly suggest that this extraordinarily

small change in volumes that we are talking about would give rise to a yet smaller extraordinarily small change in prices?
A. It depends upon how precisely Postcomm looked to match revenues and costs given what I have said.
Q. Yes.
A. If volumes fall, then your price of your product has to rise to cover your cost. They had detailed econometric models, they had external consultants looking at this, but I cannot tell you what they would have done.
Q. Let us look again at something else that Mr Harvey has done which is --
SIR IAIN MCMILLAN: Mr Ward, could I come in and ask a quick question here?
MR WARD: Of course.
SIR IAIN MCMILLAN: If the loss of volume allowed a price or triggered a price rise to offset that loss of income, is it possible then that that increase in price could cause volume to be lost again, on top of the first loss of volume?
THE CHAIRMAN: A never-ending spiral.
MR WARD: Sir, you have a question that I have asked myself frankly.
A. It is an iteration. You have to juggle between the implications of putting up prices, the implications for

volumes, the implications for costs and you have to triangulate within that. That is what these models are trying to do.

SIR IAIN MCMILLAN: So the balance of advantage has to be judged?

A. Yes.

SIR IAIN MCMILLAN: Right. Thank you.

MR WARD: That would be quite a difficult exercise, would it not?

A. Well, it is an exercise which Royal Mail does all the time, trying to understand what happens to its prices and what happens with volumes and what happens to its costs, and it debates it with the regulator --

Q. Indeed.

A. -- on a frequent basis. The regulator takes external advice, so a lot of people have thought hard about the question.

Q. You would agree that with something like a volume forecast, there is scope for a very wide range of views?

A. There is, although, obviously, when the regulator sets the regime they crystallise on a particular view.

Q. Let us look at -- sorry, let me just see if you have this. Turn to your tab 28, please. For us it is {E/52}. I hope your tab 28, Mr Bezant, is going to be Harvey supplemental report, plausibility --

A. I have that.
Q. Super. Can we go to page 128 {E/52/128}? This is a table that Mr Harvey has prepared looking at PC2 and PC3 where he says:

"I have summarised the differences between Royal Mail's and Postcomm's volume forecasts in the table below. Overall, these differences range from 234 million items to 1.856 million items."

He says:

"In view of the extent of this uncertainty, and the fact that the volume change implied by Supply Pass-on of 50% is at most 2 million items, it appears highly unlikely that the volume forecast used in the setting of price caps would have differed between the factual and counterfactual scenarios."

Because you see the volume forecasts are up in the 20 billion territory here and the point Mr Harvey is making is that this difference of, at most, 2 million is just too small to matter here, is it not?
A. I see the point he is making. I do not know if he is comparing forecasts from the beginning of the process with Postcomm's final proposals, where things had moved in the interim in terms of expectations for the market. I do not know.

But what matters is Postcomm's final view when setting the regulatory regime and if certain things had been different in the way they set that regime and understanding the interactions we have just discussed, whether they would have expected a lower volume because certain prices were higher and then got into this iteration as to what prices they should allow for to offset that, and then work through the further iteration of that before settling on kind of a net outcome.

Q. Let us just try and summarise what would need to happen here. If the overcharge is going to cause -- if the volume effect is going to cause an increase in the price. The first thing we have to have is the Postcomm's forecast of volumes to actually be 1 or 2 million lower because of the increase in price caused by the overcharge, do we not? That is the first thing.

A. But there is nothing untoward about that if that is what is implied by the counterfactual information available to you. We are not comparing the actual and the counterfactual. We are starting with a different set of economic assumptions about the business that has implications for prices, volumes and costs, and the regulator is thinking about that. They are not saying it is a little bit different, let it be. They are starting with something different.

Q. No, but that 1 or 2 million reduced volume has to be in

Postcomm's forecast for this effect to happen, does it not?

A. The difference in the volume expectations, to the extent that the modelling suggests them, based on the different inputs in the counterfactual, they would come into Postcomm's modelling considerations.

Q. Depending, of course, on just how refined Postcomm's modelling actually is, whether it would pick up a change of that scale?

A. I cannot comment on Postcomm's modelling. I am saying in principle they would understand the need to model --

Q. In principle, yes, but what we cannot say is in practice whether it would have happened, can we?

A. No, but they are trying to match costs and revenues, if you remember that proposition.

Q. Yes. Broadly.

A. So, therefore, they understand the need to make sure that the volume effects and the price effects and the cost effects are all integrated in arriving at the overall outcome.

Q. It would be just useful to remind ourselves of what they actually said about that because it features quite heavily in the argument. This time we need to go to {I3/374}. I have to find out which reference this is. So it is tab 20 for you.

A. I have got that, thank you.

Q. Thank you. Going to page 70 {I3/374/70}, this is the Postcomm final document for PC2, just scroll down a little further, please. I think this is what you were just alluding to, 7.44:

"In setting the level of the control, Postcomm has set the allowed revenues so that on Postcomm's central view of volumes, operating, capital and renewals expenditure, Royal Mail will be broadly cash neutral~..."

I think that is what you were just alluding to, that paragraph?

A. Yes.

Q. It is a point I think I made yesterday. This is quite broad language -- sorry, it actually says "broad". It is broadly cash neutral based on its central views. It is hard to read into that, is it not, that 1 or 2 million extra volume would make a difference to that proposition?

A. If they had a different central view -- you keep imagining that they live in the actual world and then the next day we change something. They do not. They live in the counterfactual world. If they have a different central view of volumes because of the different configuration of costs and the implications for prices to recover those costs, then they will have a different central view. This sentence does not dissuade from that. What they are trying to do in their central view is match costs and revenues taking into account the interactions.

Q. It is so small, though, that the question that then arises, let us suppose that is right and their forecast volumes would actually have been 1 or 2 million lower, even though, as is accepted, we do not really know how they did it. If this argument is going to be right, the actual price set needs to be different. The price set actually has to be higher, does it not?

A. If the -- the prices of certain -- yes, the price has to -- the price -- when you mean the price set, you mean the revenues allowed?

Q. Or the price cap that they set in light of the revenues allowed.

A. Net, it has to take into account volume effects, yes.

Q. We debated yesterday whether it was granular enough to pick up the whole overcharge. We spent lots of time on that yesterday, I am sure you --

A. Yes, and I am pointing out to you they are not picking up the overcharge, they are dealing with a different body of costs and taking that into account.

Q. Okay, I understand what you are saying but the question

that we are really focusing on here is: is it plausible that the price would actually have been higher because of this tiny volume change than otherwise would have been the case? That is the question.
A. It is not a tiny volume change. It is a different volume implication having a different set of costs. So they have a different model.
Q. Yes, but --
A. But it is not wrong because it is different from the actual world.
Q. I am not suggesting it is wrong.
A. It is right in the counterfactual world where a different set of costs exist. It is consistent with the counterfactual world --
Q. Yes.
A. -- where a different set of costs exist. So they model, sensibly and consistently, in the counterfactual world based with the cost and the volume implications that they have and the price implications and the interactions of those. That is what they model. They model coherently in the counterfactual world. If it is slightly different, because it needs to be slightly different to the actual world, none of which they know about, they do it because it is coherent in the counterfactual world.

THE CHAIRMAN: I am not sure we are talking about the counterfactual world, are we? We are talking about the actual world, whether -- we are assuming there was a pass-on of the overcharge and how the volume effect would have affected the price setting.

MR WARD: That is it, sir.

A. Right, apologies. Going back to this proposition, because they were trying to do this, then they would have taken these factors into account at one level. I cannot tell you in practice what they did because I do not have their models.

Q. No, indeed. So at a high level of abstraction, that is obviously right. As ever, I am trying to leave that level of abstraction and look at what actually happened here.

We have volumes in and around the 20 billion figure, 20 billion. We have a change in volumes of 1 to 2 million, depending on exactly which year we are talking about. We have prices that are set, whole number price increases of RPI, of 3% or 4%, depending on whether we mean PC2 or PC3. We have RPI X factors set in the way we discussed yesterday. It is not remotely plausible that this tiny change in volumes could have somehow led to a different price as compared to a world where those volumes are not lost. That is the point

that I am putting to you.
A. It depends upon how these assumptions would have affected their modelling, and I cannot answer that question because I do not have their modelling.
Q. Okay, that is fine. I will just say finally that, if and to the extent, I am not sure, that this also refers to unregulated prices, Professor Neven's argument, one would say exactly the same thing, that this is simply too fine grained to be picked up in any commercial price setting. Would you accept that?
A. I think the relationship is weakened in a commercial price setting but, again, I do not know enough -- that is Professor Neven's analysis.
MR WARD: Okay. Well, I will ask him about it as well. Thank you very much, I have no further questions.
THE CHAIRMAN: Just picking up on that last point about volume, if the regulator is taking into account the volume effects, then it shows that -- it is a further example of the amount of judgment that is going into the ultimate price setting, does it not?
A. There is judgment in the sense of trying to accommodate the economic interactions, yes.
THE CHAIRMAN: Yes.
A. That is a part of the regime anyway and the economic judgments they make --

THE CHAIRMAN: Yes, you have to take into account a whole bunch of factors.
A. Yes, you do.
THE CHAIRMAN: Any re-examination?
MR BEARD: I have one or two questions, they are really just follow-up clarifications maybe from yesterday's material, if I may.
THE CHAIRMAN: Okay.

Re-examination by MR BEARD

MR BEARD: Could we go back to yesterday's transcript so {Day16/187}? Just picking it up at line 25. It will just have to be on the screen.
You will see this discussion which runs from 187/25 and if you could just read down through to page 188, line 13. (Pause).
A. I have read that, thank you.
Q. Yes, you will recall it. If we could just go to the document that was actually being referred to here which is {I3/374/21}. We just need to scroll down into the "Structure" section, thank you. So this was what you were taken to in the context of this, and Mr Ward took you to (a) and the first sentence of (b). Do you remember that?
A. Yes.
Q. Then if you just read down, he did not take you to (c).

Just sort of completing the discussion here:

"A correction factor will require Royal Mail to reduce prices in later years ..."

Are you able to explain to the tribunal what is being referred to there and how it might be relevant to any discussion of pricing up to the cap?

A. So to the extent that -- you have a cap in each year but to the extent you undershoot in one year, you can kind of carry that forward as credit to the next year, and to the extent you overshoot, you need to under-react in the next. So there is discretion and latitude over the period of the price control to calibrate to the cap.

Q. When you say discretion, that is for Royal Mail --

A. For Royal Mail. They have got the ability over time to try to reach the overall cap, even if they do not hit it within a particular year.

Q. Right. Thank you.

If we can just go to page 197, line 4 {Day16/197:4}, this is in the context of PC2 I should say. If you just read through there from line 4 and then down on to page 198 at line 15, just to give yourself some context. (Pause).

A. I have read that.

Q. Lovely. I just want to take you to the document that you were being asked about, which is {I3/374}. We will pick it up at page 70, please {I3/374/70}.

So this is February 2003 again, a Postcomm document. It is in the "Setting revenues". I think Mr Ward took you to some of these preambular paragraphs.

Then if we just go through to the next page. If we could go down, please {I3/374/71}. I think he went to these alternative revenue profiles and he took you to the table that is on the following page {I3/374/73}.

Now, you will recall that Mr Ward focused particularly on option 2 and on that final column where he says that you have got 17 billion revenue and 21 million cashflow. Obviously we have heard the theme of it is a very, very big number and this one is a very, very small number and so it cannot make any difference on Mr Ward's case.

Could you just explain what is actually going on in this table and each of the rows so that we and the tribunal understand what is being described here?

A. So in the context of PC2 and the objective of matching -- operating a capital cost over the period of time to allowed revenues and doing that by reference to an RPI minus X framework, you need to calibrate so that your projected costs and your projected revenues match as closely as possible. The three options are considering different ways of doing that.

Option 1 is doing it as closely as possible and, therefore, you are getting revenues within 2 million of your costs, because the difference is shown as minus 2 there, but your revenues are slightly less than your projected costs, but highly carefully calibrated in terms of your expected revenues.

The other two options are looking at slightly different patterns over time, taking into account considerations as to Royal Mail's desire to put prices up to start with and/or a particular pattern that may or may not be more attractive to consumers. But in each and every case, they are thinking about how you can set revenues and costs that are very closely connected, in one case by 2 million, in another case 21 million out of 17 billion, and in the third case 17 million out of 17 billion.

Q. Thank you, that is helpful.

If we could just go back -- no, I think I can leave that one in the light of the answer you have just helpfully given.

Can we just move on to PC3, picking it up at page 202 in the transcript, please {Day16/202:20}. Mr Ward was asking you about Postcomm's final decision for PC3. You probably remember that. Then he took you through various paragraphs.

If we could go through to page 203 {Day16/203:18}, picking it up at line 18. He says:

"So that is how we end up with a round number of 4%, which is a matter of regulatory judgment [he says], and then an almost peculiarly highly granular RPI X to two decimal places. It has got nothing at all to do with a highly refined judgment of RPI X, it is just a regulatory judgment [he is saying] ..."

You say then, if we just go over the page, that you do not agree with that and you talk about the various objectives. If you could just read down through that page to line 4 on page 205 {Day16/205:4}. (Pause).

A. I have read that. Thank you.

Q. Thank you. You talk about you have got to get back and solve the equation. Could you just clarify, when you say "equation", what you are talking about in this context?

A. Well, once again there is a set of projected costs and there is a pattern in prices that you are looking for, such that over the period of time in question you recover all of those costs and you make a profit, the RAB system and so on. But it is being set to a very high level of precision again, you are trying to marry the two quite closely. So, again, you can think about your RPI minus X glidepath, it is the same consideration. In this case, if the regulator is allowing a particular figure, like 4% in year 1, but you are still trying to get a very clear connection between total projected costs, total projected revenues, allowing for a profit, then you have a very precise mechanism by which to do that, which is the two decimal place X factor, which you can then adjust very acutely if you have a different set of costs and you are still trying to achieve the same outcome of matching your revenues with a profit element to that set of costs.

Q. Understood, and you refer to the equation over years 2, 3 and 4. So are you talking about the same equation over 2, 3 and 4 or different equations or --

A. No, I am just talking about the overall equation, saying you could have a glidepath that fell consistently over time but if you make a particular assumption in year 1, in this case to allow a price increase, for example, but you are still trying to make sure that over the duration of the regime you are recovering your costs carefully and exactly and making a particular set of profit, then you only have X -- you then have to adjust X in years 2, 3 and 4 but it is all part of the one consideration.

Q. Understood. Thank you.

THE CHAIRMAN: Do you have much more, Mr Beard?

MR BEARD: One more. It is just going back to the points on

Mr Cahill's -- the evidence on Mr Cahill.

If we could just go to transcript {Day16/222}. Mr Ward put to you there, you will see, certain points in relation to what he said was Mr Cahill's evidence. We will make submissions in due course about Mr Ward's characterisation of that evidence.

You answered over the page, on {Day16/223}, and you referred there, further down, about what was being done at different times. You said:

"Earlier in the period, they were not inputting prices to see what the margins were, if I have understood it; they were inputting contributions to see what the prices were ..."

Could we go to {D/IC5/17}? This is Mr Cahill's statement. He was referring to a pricing model. Was that what you were referring to in your recollection? Sorry, we may need to scroll down slightly.

A. Yes, I think that is the pricing model.

Q. Let us just go -- because it is exhibited, so it is {I2/2}, please. Sorry, it is just being downloaded on to the screen. Do you remember looking at this at all?

A. Yes.

Q. Do you have any observations in the light of the exchange you had with Mr Ward in relation to this?

A. Well, I think this is the model where you have margin over costs in order to arrive at a price.

MR BEARD: Right. That is your understanding of it. Thank you very much.

I do not have any further questions.

Questions by THE TRIBUNAL

MR RIDYARD: Mr Bezant, just going back again to yesterday's evidence, there was a discussion of a chart which was in one of -- in your first report where you did this correlation analysis between fully allocated costs and prices for Royal Mail.

A. Yes.

MR RIDYARD: I do not expect you to know the precise answer to this question but just as a sort of thought experiment, I wondered what would happen if you adjusted that analysis, so instead of putting in the actual fully allocated costs, you made an assumption of, I do not know, a 10% infringement overcharge and put those cost numbers into this model, keeping the prices the same so there was no cost pass-through, what do you think -- what effect do you think that would have on your correlation between those new costs and the prices? Do you think it would differ very much from 0.97?

A. No, I do not think it would.

MR RIDYARD: Okay. Thank you.

THE CHAIRMAN: Thank you very much, Mr Bezant. That is the

end of your evidence and you are free to go.
A. Thank you.
THE CHAIRMAN: All right. We will calculate the time left available to both of you. I think Mr Beard has a bit longer, if it is Mr Beard cross-examining on financing.
MR WARD: Sir, you will recall that Mr Lask has been dealing with financing matters and I hope I will not be thought guilty of either lack of disinterest or discourtesy if I leave Mr Lask to fend for himself this afternoon.
THE CHAIRMAN: All right.
MR WARD: Thank you very much.
THE CHAIRMAN: You have left him a shorter amount of time perhaps than he would have wanted.
MR WARD: There has been a negotiation with junior counsel!
THE CHAIRMAN: All right, that is fine. So we will start at -- we will start at 2.10 then.
MR WARD: Thank you, sir.
THE CHAIRMAN: Thank you very much.
(1.11 pm)
(The short adjournment)
(2.10 pm)
THE CHAIRMAN: Good afternoon.
MR LASK: Good afternoon, sir.
This afternoon we have Mr Earwaker giving evidence. He obviously needs to be sworn in.

MR JOHN EARWAKER (affirmed)

THE CHAIRMAN: Thank you, Mr Earwaker. Please sit down and make yourself comfortable.

I see you have got some bundles there. No doubt you will be taken to some of the contents soon.

MR LASK: Sir, if it suits the tribunal, I was proposing to introduce Mr Earwaker's evidence in the same way that Mr Beard introduced Mr Bezant's evidence yesterday, in an abridged fashion.

THE CHAIRMAN: Yes.

Examination-in-chief by MR LASK

MR LASK: Mr Earwaker, you have provided three reports and signed a joint expert statement. Are the contents of those documents true to the best of your knowledge and belief?

A. They are, yes.

Q. Thank you.

Do you have any corrections you wish to make to any of your reports?

A. Yes, I do. I have one correction I would like to make, if that is possible. Just in preparing overnight, I have identified that I made a numerical error. It is in -- probably the joint expert statement is the place to look, if it is possible to go there?

Q. That is at {E/IC85}.

A. Page 20 (E/IC85/20}.
Q. That can be displayed, thank you.
A. One of the issues that Mr Delamer and I were not able to agree on was the cost of debt in the year 2013/14. That was the year of Royal Mail's flotation. I, in my methodology, tried to take account of the debt that was in place both pre-flotation, in the first six months of the year, and post-flotation, in the second six months of the year. In calculating the 3.5% value that appears in the penultimate column in row 2013/2014, I inadvertently forgot to include the cost of one of the pieces of debt that Royal Mail had prior to its flotation. It had a shareholder loan that was -- had an interest rate of 12% and I mistakenly lost track of that piece of borrowing as I produced this table. So the number there should be 5.0%, I believe, instead of 3.5%.
If you go on to page 22 {E/IC85/22}.
THE EPE OPERATOR: Are you happy for that to be shown as well?
MR LASK: Yes, thank you.
A. The relevance of this correction is limited to the alternative case where the WACC is not appropriate. We have to look to an alternative and Mr Delamer has provided some alternatives. In my column of this table, the 2013/14 value would again move to 5.0%, just to take

account of that extra interest that I --
THE CHAIRMAN: It is the same point?
A. The same point again, yes.
THE CHAIRMAN: Okay.
MR LASK: Thank you. I do not have any further questions but if you wait there, Mr Beard will have some questions for you.
A. Sure, thank you.

Cross-examination by MR BEARD

MR BEARD: Good afternoon, Mr Earwaker.
A. Good afternoon.
Q. So I want to ask you some questions about your approach to the claim for interest in this case. In broad terms, you argue that simple interest rates should not be used, it should be a compounded rate that should be applied, and the relevant rate you espouse is the weighted average cost of capital; correct?
A. That is correct.
Q. I am just going to put that in context if I may. Can we just call up {E/IC47/80}?
You will be familiar with this, Mr Earwaker, but if we just scroll down so we can see the figure. Here, we are comparing your preferred rate in red with simple interest rates. This is from Mr Delamer's report, but you are familiar with that table?

A. Yes.

Q. You do not actually disagree with the maths on that I do not think?

A. No, that is correct.

Q. No.

Then if we scroll back actually just to page 76 {E/IC47/76}, so that was a -- that was -- that table was against simple interest and this is your measure against different compound interest computations that we will come back to. So the red is what you say, and I think -- just in making the corrections, you referred to what I think you referred to as alternative calculations and there are four set out there; correct?

A. That is correct.

Q. Thank you.

You are nodding, but you are also answering; that is great because it comes across on the transcript. I am not preventing head movement, but just if you can ensure that you say yes or no, or whatever else that you want to say, within reason, that would be great for the transcript.

Now, I think there is some common ground on what you say about how the WACC should be calculated or at least I think we can agree on how you say it should be done. I am not going to take you through your report, but

I can go to it if there is anything controversial or you want to. But you calculate separately the cost of debt and cost of equity and then combine them into the weighted average cost of capital; correct?
A. That is correct.
Q. Right.
You calculate Royal Mail Group Limited's cost of debt over the period '97 to 2021 by taking interest rate figures from the available documentary material; correct?
A. That was my approach, yes.
Q. Yes.
Then, you explain that the cost of equity is the return that shareholders require to put money into a company, and you say that is not observable and so you use modelling techniques to calculate the cost of equity?
A. That is correct.
Q. Yes.
Then, you use a formula called the capital asset pricing model in relation to the calculation of the WACC; that is correct, yes?
A. That is correct.
Q. Yes.
The capital asset pricing model has three

inputs: the risk-free rate, the expected market return
and the beta; correct?
A. Yes.
Q. We will come back to those a bit later, but I am just making sure we have got the groundwork sorted.
Once you have calculated the cost of debt and cost of equity, you combine them using this formula, using a formula that you say ensures they are properly weighted; that is correct, is it not?
A. That is correct.
Q. Yes. Okay.
You set out calculations of the WACC in your report. Now, those we have treated as confidential, but I am just going to raise with Mr Lask whether or not actually they are, in the light of the fact that we were just seeing the back end calculations.
MR LASK: Which figures?
MR BEARD: I am just thinking about any WACC and cost of debt figures, given that you just put the others up. But if Mr Lask can take instructions, it may mean we have to do less in confidential session. There will be some bits during the course of this afternoon where we may have to go into a confidential session, but the less we have to do that, the better.
A. Understood.

Q. Sorry, that was an indirect question to Mr Lask rather than to you, Mr Earwaker.

So, first of all, I want to turn to look at one of the statements which effectively underpins your approach for the use of the WACC. I will go now to -- I will pick it up in your third report. So this is {E/IC60/24}. I have given the wrong reference, have I not? I have given the same reference -- yes. No, sorry.

So, picking up at 3.9, just under your heading "The relevance of the WACC", here, you are actually -- because we are in the third report, you are actually summarising Mr Delamer's objections to the use of the WACC; do you see that there?

A. I do.

Q. Yes.

I am not going to say that you fully reflect all of his arguments, but that is a matter that can be raised with Mr Delamer in due course.

If we go down to 3.11, you say:

"In the case of point (c) ..."

Which is the point above in 3.9, "the way in which equity finance took the form of a use of Royal Mail's retained earnings rather than actual injection of fresh equity".

In relation to (c):

"... Mr Delamer has pointed out that Royal Mail did not pay dividends between 1997 and 2014. However [you say]:

"Between 1997 and 1999, The Post Office Corporation did pay a proportion of its profits to the UK Government under 'External Financing Limit' rules ".

If we go over the page {E/IC60/25}, we have various other points. I will just let you read through those.

A. I am familiar with these paragraphs.

Q. Thank you.

Paragraph 3.12:

"I take two things from this chronology. First, Royal Mail was to all intents and purposes a dividend paying company between 1997 and 2001."

Then:

"Second, although I cannot say for certain what would have happened differently, it is likely that Royal Mail would have paid dividends after 2001 ..."

I just want to have a look at this.

You were not in court when Mr Jeavons gave evidence, were you?

A. I was not.

Q. No.

Have you reviewed the transcript of Mr Jeavons'

testimony?
A. I believe so, yes. I think that is right.
Q. Did you speak to Mr Jeavons at any point prior to the preparation of your report?
A. I do not think I did, no.
Q. No.
Did you speak to any other individuals within Royal Mail involved in financing at Royal Mail before you produced your report?
A. I do not think I did, no.
Q. No, okay.
So let us just look at the transcript of Day 4, picking it up at page 58, if I may. So this is the testimony of Mr Jeavons {Day4/58}, and I am going to take you to one or two bits in it. The first bit, just picking it up at line 12, I just want to pick up something in relation to the accounts in 2000, if I may. It simply confirms the answers you have already given but could we go to it? This is the Post Office accounts 1999/2000, so let us just go to that document so you can see it. {I3/63/1}, please. You actually have some of these documents in a hard copy bundle.
A. I am okay with the screen at the moment.
Q. You are okay with the screen? Great, we will carry on with that then, that is fine. Thank you.

If we can just go over to page 3, please, in that document {I3/63/3} and now we have to do the focusing in. On the left-hand side, fourth heading down, would that be possible, please? Thank you. You see there "Future dividend":

"Current legislation does not permit the payment of dividends by The Post Office."

So The Post Office at that time was the name of Royal Mail Group Limited, so there is no issue. So these accounts were saying the current legislation does not permit any payment of dividends. Had you looked at this document before you prepared your report?

A. I had, yes.

Q. Yes. I see.

So let us -- then it goes on:

"£151m has been reserved as a 'future dividend' to be paid to Government after enactment of the Postal Services Bill."

But we are talking about 1999/2000.

If we could go back to the testimony of Mr Jeavons, so that is transcript {Day4/58}. As I was saying, line 15:

"So this is your accounts, and if we could go down to page 3 ... this is actually quite hard to read. It is the fourth heading, 'Future dividend'."

Then I took Mr Jeavons to that, which I have just taken you to.

If we could just go over the page, please {Day4/59}:

"So essentially this is your point ..."

So this is to Mr Jeavons:

"... that you were making ... there was a reservation of monies, but there were no dividends and pay-outs being made.

"Yes."

So just to be clear, Mr Jeavons confirmed the position that Royal Mail Group Limited had put in its accounts in 1999/2000 that there were no dividends and pay-outs being made; do you see that?

A. Okay, yes.

Q. You have no reason to doubt that factual statement, do you? You are not here as a witness of fact? No?

A. No.

Q. So Mr Jeavons had made it very clear that Royal Mail Group was not a dividend paying company. Indeed, he made it clear that it was not a dividend paying company in the period right up until 2013; are you aware of that?

A. Yes, but he does talk about the mails reserve.

Q. Yes, we will come on to the mails reserve. But let us just be very clear: Mr Jeavons has given evidence which,

quite rightly, you do not challenge that Royal Mail Group Limited was not a dividend paying company right up until 2013. You understand that?
A. That is factually correct.
Q. That is factually correct.
So when you say to all intents and purposes Royal Mail Group Limited was a dividend paying company between 1997 and 2001, you mean to all intents and purposes except for the factual proposition that it was not?
A. So what I am doing here is I am bringing in what happened subsequently with the mails reserve and the use to which the monies in the mails reserve are put.
Q. Right. So you are saying -- you are not disputing the fact that there were no dividends paid?
A. I believe, until Royal Mail was reconstituted into Consignia in around 2001, it was not able to pay dividends legally. From 2001 onwards, it was legally able to pay dividends.
Q. It did not prior to 2013, did it?
A. It paid to the mails -- this is why I think we have to look at the chronology altogether. It is what happened to the monies that you have identified in, say, the 1999/2000 --
Q. It is a simple question. I am going to come to the

mails reserve, Mr Earwaker. I am not going to duck out of dealing with the mails reserve.

A. Okay.

Q. But there were no dividends paid by Royal Mail Group Limited prior to 2013, were there?

A. No dividends, no.

Q. No. No. Right.

Now, I asked Mr Jeavons about the financing limit that was actually in place before the mails reserve, so let us just touch on that, shall we? Then we will come on to the mails reserve? If we could look at page 60 in the Day 4 transcript {Day4/16}.

You will see, picking it up at line 16:

"... the mails reserve was created in 2003."

I think you accept that; yes?

A. That is right.

Q. Yes.

"Prior to that, there was a financing limit that was placed on Royal Mail. It was effectively a profit cap ...

"Yes?"

I am just reading out, and Mr Jeavons agreed and said:

"... it was a negative financing limit."

So this was making clear that up until 2003, even by reference to your mails reserve issues, there was no dividend being paid; correct?

A. No payment of dividends, correct.

Q. Yes.

Then you say in relation to the mails reserve period things were slightly different.

Now let us just see {Day4/55} if we could. This was a question from the chairman to Mr Jeavons:

"Were dividends ever paid to the government?

"I do not think so in this period [I think that is the period to 2013, I will double-check]. There was a mechanism in place where retained or what were considered to be surplus retained earnings were ringfenced into a special reserve called the mails reserve, on the balance sheet, and that was invested in government bonds, gilts, so that they had the cash, and it was ringfenced such that the company did not have access to it without first going to government to seek permission."

He says:

"... that was [sort] of in lieu of dividends."

A. I agree --

Q. This is what you are -- this is what you are referring to as the mails reserve and you would agree with Mr Jeavons' description of it?

A. I can explain if you would like me to.
Q. Could you just answer the question first, and then feel free to explain?
A. So, yes, I agree with the statement --
Q. Thank you.
A. -- where he replies it was in lieu of dividends --
Q. Yes, so in lieu of dividends, you are suggesting here.
Just to be clear, what was required of the mails reserve, that it was invested in government bonds and gilts, so particular financial instruments that would provide a return; correct?
A. When it was not being used for other purposes, correct.
Q. Yes.
So effectively there was a government mandate that you had to invest the money that you had in particular sorts of instruments; correct?
A. That is my understanding.
Q. Yes.
I am not going to try and get into the full ramifications of what government bonds might mean, or gilts, because I know that you can have variable interest rates and fixed interest rates and all sorts, but essentially, what these instruments did was had the government pay Royal Mail Group Limited certain amounts of money in relation to the instruments they held;

correct?
A. Sorry, could you repeat that for me?
Q. So if you invest in a gilt --
A. Yes.
Q. -- you expect to get some kind of return, do you not?
A. You get a return, yes.
Q. Yes.
So what was happening was Royal Mail Group Limited was being required to take certain sorts of financial instruments, gilts and government bonds; correct?
A. Correct.
Q. It was earning a return on those government gilts and bonds, was it not?
A. It was earning a return and paying that return into the mails reserve.
Q. Yes, so what it was doing was just accumulating that money; correct?
A. Correct.
Q. So, actually, the UK Government was effectively paying Royal Mail in relation to the gilts and bonds, correct?
A. As the issuer of gilts you mean?
Q. Well, Royal Mail is required to invest the mails reserve in gilts and government bonds; correct?
A. Correct.
Q. Then it gets a return on those gilts and government

bonds, does it not? Royal Mail Limited.
A. That is correct.
Q. Yes.
Now, it is a funny sort of dividend, is it not, in those circumstances, the idea that you are investing in an instrument that you are specified to invest in and then you get paid for it at the particular rate that the instruments provide for? That is not a dividend to the person in relation to whom you have purchased the instruments from, is it?
A. It is not yet, but it is where you hope you are going next in the story, that it becomes a dividend.
Q. Well, we say not, because what you have is a situation where it was ringfenced and you were not getting any dividends paid in relation to these arrangements. What it was was a form of investment by Royal Mail Group Limited, was it not?
A. It was initially, but, again, we have not got to the stage where we talk about what was done with that money.
Q. So you are saying that when the money is then released, it can then be provided and treated as a dividend to government, even though, throughout that period, actually what has been happening is that, on the balance sheet of Royal Mail Group Limited, there are a collection of assets in relation to which Royal Mail

Group Limited itself is being paid; correct?
A. Would you like me to explain why I think it is a dividend, because I am not following the --
Q. Well, if you could answer the question and then feel free to explain, please.
A. Okay, could you repeat the question for me then, please?
Q. Of course. So you are saying that when the money is released it can then be provided and treated as a dividend, even though, throughout the period, actually what has been happening is that on the balance sheet of Royal Mail Group Limited, there are a collection of assets in relation to which Royal Mail Group Limited itself is being paid; correct?
A. That is correct.
Q. Thank you.
THE CHAIRMAN: Do you want to go on and explain?
A. Yes. So what is happening here is that the government has, I think under the Postal Services Act, required Royal Mail to form these mails reserves. So at the point of creation in 2003, my recollection is somewhere to the order of £1.5 billion of accumulated profits were transferred into the mails reserve.
It is correct to say that, for the period in which those monies were in the mails reserve, they were in government gilts, they were earning a return through

the investment into government bonds. But the reason why I describe them as being akin to a dividend, or words to that effect, is the government, at that point when the reserve was created, had the opportunity to use those monies for purposes of its choosing. So, from 2003 onwards, it would direct Royal Mail to put money in, for example, The Post Office network which was struggling financially at the time.

Then, my recollection is, somewhere around 2007, what was left in the mails reserve was then actually paid up by the claimant to the parent company and the mails reserve was essentially extinguished to zero at that point. Again, at that point, the owner of Royal Mail had the opportunity to use that money for its purposes, again, Post Office, the pension fund, things like that.

So I think you are correct to say that once the reserve was created it did accumulate in the way that you have described. The reason why I point to that as being eventually akin to a dividend is, when the government chose to use that money, it was essentially taken out of the postal business and used for government purposes elsewhere --

THE CHAIRMAN: Are you saying it was effectively under the control of the government?

A. That is my understanding.
THE CHAIRMAN: Which was the shareholder?
A. That is my understanding.
MR BEARD: Well, with respect, that is not right, is it? Because what the government could do with the mails reserve was actually use it for the purposes of the business, and all of the examples you have just given are part of the Royal Mail business. What the government did not do was ever take that money out and use it for other purposes. That money was ringfenced within the mails reserve and all of the examples you have given are investments in various aspects of the Royal Mail Group business, are they not?
A. I am not sure that is correct at the very end. So, I believe, in 2007, the money was paid out of the claimant company to its parent, and at that point the money was applied for purposes decided by the government.
Q. Sorry, when you say the money was paid out of the claimant, which is the right distinction to make here, to the parent company, you are meaning Royal Mail Group plc; correct?
A. That is my recollection.
Q. Yes. So all of the payments you have referred to refer to payments to Post Office, to Royal Mail pension funds,

to the parent company, which are all uses of the mails reserve for Royal Mail Group business, are they not?
A. That may be correct. That is ...
Q. That is in fact the constraint that existed in relation to the mails reserve, is it not?
A. I do not know.
Q. You do not know. So the only examples you have given are all related to investment in the business. We understand that that was the constraint that existed in relation to the mails reserve and there are no examples of the government simply taking money out and putting it, for instance, into the consolidated fund or using it for some other purchase?
A. No. No, I do not believe that is correct.
Q. No.
SIR IAIN MCMILLAN: May I ask a question, Mr Beard?
MR BEARD: Of course. Sir Iain, just before you do, just a correction, I said "plc", it would have been Holdings, the parent company, but I do not think that changes the issue that we just discussed.
SIR IAIN MCMILLAN: Thank you.
It is just a quick question about the gilts that were purchased. Were they purchased on the stock market at the prevailing value on the day of the purchase and was the yield that you used to quantify the income the

difference between the par value yield and the real yield dependent on the price of the gilt at the time of the purchase?
A. I am afraid I do not know the answer to either of those questions, so I do not know the arrangements for purchasing. I did not actually use the gilt yields purchased by Royal Mail in my analysis. I apologise.
SIR IAIN MCMILLAN: Thank you.
THE CHAIRMAN: Can I just ask a question. Do we know the actual terms of the mails reserve?
MR BEARD: I think we can check those --
THE CHAIRMAN: All right.
MR BEARD: -- but my understanding is that (a) they were constrained because -- and that in fact all of the uses of it to which it were put, as in fact Mr Earwaker has accepted --
THE CHAIRMAN: No, I understand that.
MR BEARD: -- were into the business, and our point is that does not constitute a dividend. If you --
THE CHAIRMAN: No, I understand that, but I just want to know --
MR BEARD: Yes, we will check that. Sorry. Of course.
THE CHAIRMAN: -- whether the actual terms prevented it being used outside the Royal Mail business.
MR BEARD: I believe that is the case, yes.

THE CHAIRMAN: Okay.

MR RIDYARD: Does Mr Earwaker accept that? I thought he said that was not -- in [draft] line 7, he said "I do not believe that is correct".

MR BEARD: No, I think, in the end, he -- when he said initially it was not correct, he then gave examples, as I recall, of all of the investments being into the business. I think he was not clear about whether or not this was a formal constraint. I think I am not misrepresenting the position.

I will ask the question again.

I think you have accepted that all the uses of the mails reserve of which you are aware were reinvestments in Royal Mail Group business activity?

A. So, I do not know the arrangement between Royal Mail -- the claimant, Royal Mail company -- and the pension fund. So I am hesitant because --

Q. Understood.

A. -- as an expert, this is not my field of expertise at all. I know, in 2007, the money was paid up from the claimant company to its parent. I do not know what happened to it after that point.

Q. Let me clarify. I understand your concern not to overreach in relation to matters, but when we are talking about the pension fund, we are only talking

about Royal Mail pension fund. We are not talking about a more general civil service pension fund, are we?
A. That may be right. I genuinely do not know.
Q. It might just be worth just confirming this. I mean, you are taking your information, as I understand it, from Mr Jeavons' witness statement in this regard; is that right?
A. Not solely, no.
Q. Not solely. It might be worth just turning up Mr Jeavons' witness statement, because I think that confirms that at least his references are all to internal business matters. It is {D/IC7}, please. If we can just pick it up at 19.8.
A. What page?
Q. I am so sorry, 45 {D/IC7/45}, my apologies.
You will see there:
"The 'Mails Reserve' that I [have referred to] above ... was a special reserve fund created by RMGL that the Secretary of State ... could direct [Royal Mail] to allocate for a general or specific purpose in accordance with section 72 of the Postal Services Act 2000."
I think that, sir, is where we end up going to for the answer to your question. I just did not -- I do not have it to hand.
THE CHAIRMAN: So it is in the Postal Services Act it is

probably related to --

MR BEARD: Yes.

THE CHAIRMAN: Yes.

MR BEARD: I think, yes, the clue may well be in the name as they say.

"The Mails Reserve was created by RMGL on 3 February 2003 in accordance with directions from the Secretary of State ..."

So this is in line with your chronology.

"... and RMGL allocated funds to the Mails Reserve ... up [until] the 2013 IPO."

Which is, I think you accepted, it was just accumulating up until that point.

"Once funds were allocated to the Mails Reserve, they were ring fenced in the 'capital and reserves' section of RMGL's balance sheet ..."

So I think you accepted that they were all on Royal Mail Group's balance sheet:

"... and therefore could not be used for working capital purposes unless the Secretary of State directed that the Mails Reserve could be [used]."

So, there he is talking about working capital within the business. I think that is tolerably clear.

"As reported at note 18 to RMGL's Accounts for the financial year 2002/03 (and as subsequently [noted] ...)

the interest accrued on the funds ... was transferred by RMGL to the fund at the year-end date. It is explained at note 17 that the amounts [were] allocated to the reserve were to be applied 'as if they were profits available for distribution ...', such that they were equivalent to dividend payments."

He refers to note 17. Then:

"The UK Government also took security over the Mails Reserve as part of the debt financing arrangements ... For a period from 2003 to 2006, the UK Government directed that the Mails Reserve be used to subsidise [Post Office Limited's] rural network."

So that is I think one of the examples you refer to?

A. Correct.

Q. Thank you.

"In August 2006, the UK Government made an equity injection of £145 million in relation to that subsidy."

So what he says there is that one should treat that akin to an equity injection, which is what I cross-examined him about in relation to these matters. But the point is that it is investment from the mails reserve into Post Office Limited again; correct?

A. That would be my understanding.

Q. Yes.

"In addition, in 2006, the UK Government released

£850 million from the Mails Reserve to set up an escrow account that could be drawn on by the Royal Mail Pension Plan in exceptional circumstances on account of the deficit in the scheme."

Now, I am not asking you to confirm that, but that is Mr Jeavons' evidence and I cross-examined him as to how those should be treated.

A. I think that is consistent with what I have been saying.

Q. Yes.

A. I may have said 2007 instead of 2006, but --

Q. Yes.

It may be consistent in chronological terms, but I think it is pretty clear that the case that I am putting to you is that it is not right to say, to all intents and purposes Royal Mail Group Limited was a dividend paying company between 1997 and 2001, nor is it correct to say that in relation to the period through to 2013. Your reliance is solely on the mails reserve in that regard, is it not?

A. My lay person's reading, because this is really not my field of expertise, was that there was a process in place and the words on the screen there were designed to create something that was similar to a dividend. You can see that from the words quoted from the act. So I, as a lay person, may have misinterpreted that.

Q. Thank you. You may have misinterpreted that, indeed.

THE CHAIRMAN: Did you cross-examine Mr Jeavons on that paragraph?

MR BEARD: On the -- I cross-examined Mr Jeavons on a series of points about the use of dividends and the mails reserve. We will go back through the transcript. I do not know that I particularly put that to him. What I was challenging him on was whether or not the -- what I put to Mr Jeavons was whether or not there were dividends paid and what payments had been made and how they had been made. So I did not necessarily take him to each paragraph in his witness statement, but I put the gist of the position to him in relation to the transcript, which was what I was in part quoting. I have not gone through all of Mr Jeavons' evidence with Mr Earwaker.

THE CHAIRMAN: No.

MR BEARD: Mr Bourke is pointing out that actually I had taken him to various of those paragraphs in the transcript, but I will leave that for closing submissions.

MR RIDYARD: Mr Jeavons did say they were equivalent to dividend payments, so is that ...

MR BEARD: Yes, he asserted that they were equivalent to dividend payments, but what I did was I put the case to him that in fact they were not dividends and in fact what was going on with the mails reserve was that they were being used, when you had permission, within the business.

Our submission is, when the fact witnesses explain that, what is in fact the case is that these are not dividends, and for the purposes of what we are talking about here, which is, is there a cost of equity, which is where we are headed in relation to this, we say, look, no dividends are being paid here and it is not equivalent to dividends for these purposes.

Yes, I think, as I recall, Mr Lask tried to get him to say that in re-examination as well, that they were akin to dividends, but we put the case in relation to that and have the factual evidence in relation to it.

There is just -- there was one more thing I did want to show you. I would like to take you to a Postcomm document if I may. It is a Postcomm consultation document of March 2004, so that is {I3/378/1}, we will pick it up at page 1 so you can see the front page.

A. Sure.

Q. Now, this is "Royal Mail Price and Service Quality Review", March 2004, "Consultation about Process, Timetable and Main Issues for the Review". Have you seen this document or looked at it before?

A. Almost certainly, but perhaps not for many years.
Q. Right.
Let us just go over to page 2 {I3/378/2}. There we can see the "Purpose of this Document":
"Royal Mail's present price control and service quality obligations are due to be revised on 31 March 2006."
So this is the consultation in relation to this, setting out various proposals.
A. Yes.
Q. You are familiar with this type of document?
A. Very familiar.
Q. Yes.
Now, if we could go to page 28, please {I3/378/28}, paragraph 4.9, so just a bit down the page, please:
"Postcomm did not make a specific allowance for any profit for Royal Mail as part of the last price control ..."
So, here we are talking about the price control that is going to run from 2006 in this consultation document, so that is known as PC3. It is saying:
"Postcomm did not make a specific allowance for any profit ... as part of the last price control ..."
So that was PC2 as it was known.
"... although it noted in the price control decision

document that the price control anticipated Royal Mail making an operating profit of 6% on its regulated revenues in the final year of the control. Postcomm did not make any allowance for profit because Royal Mail's shareholder (the Government) waived any requirement for a return during the period of the control."

Were you aware of that when you made your -- put forward your expert report?

A. No, I am not sure I follow what these words mean. But, no, I do not believe I was aware of these statements when I produced my expert report.

Q. Now, if we could go to the joint experts' statement, {E/IC85/8}, please. We see the columns, so halfway down the paragraph under "Mr Earwaker's position", you say:

"Mr Delamer states that the Claimant did not pay out dividends ... This is not correct in the case of the period 1997-99."

Well, I think we have covered that.

"Moreover, the Claimant has paid out dividends since 2014. It is not possible to know what dividends the Claimant would have paid prior to 2014 absent any overcharges."

So you are saying dividends were paid out after 2014 and then you are connecting that with a proposition that says it is not possible to know what dividends the claimant would have paid prior to 2014, absent any overcharges.

A. That is correct.

Q. Yes.

Could we go to transcript {Day4/62:16}. So:

"I think, given your answers so far ..."

This is me asking questions of Mr Jeavons again.

A. Okay.

Q. "I think, given your answers so far, that no dividends were being paid and no dividends, in those circumstances, would be paid, whatever the level of any putative overcharge ... would be. I think you agree with that, do you not?

"Answer: Sorry, could you say the question again ...?"

Reading it back, I can see why he asked that. I then had another go:

"You have indicated that no dividends were paid at any point, and I think you would agree that there would be no difference if there had been, in a hypothetical world, an overcharge on trucks, that would not have changed the position, there would still have been no dividends paid?

"Answer: It is unlikely to have been remotely material to those decisions."

Now, obviously you had not spoken to Mr Jeavons in relation to these matters prior to making your report, but he is making it absolutely clear there, is he not, that even if there had been this putative overcharge, it would have made no difference in his view to dividends?
A. He is very clear, yes.
Q. Yes, and he is the CFO of Royal Mail Group Limited, is he not?
A. That may be right, yes.
Q. Yes.

So I have been focusing on the dividends issue, but now I want to look at equity contributions.
A. Okay.
Q. So the other way effectively.

So we know the shareholder is the government, do we not, the sole shareholder of Royal Mail Group Limited?
A. Up until 2013.
Q. Yes, up until 2013, quite right.

If we could just stay with that transcript and go to {Day4/52}, please. Just picking it up at line 16, that was where Mr Jeavons was making it clear that the government owned Royal Mail Group. Then we see, at line 24, I asked Mr Jeavons:

"It is also true, is it not, that the government did not make any equity injections into Royal Mail Group

Limited business during that period 1997 to 2013, that is correct ...?

"Answer: No. No. Yes, sorry, [that] is correct."

In other words, I think he was saying: no, they did not; yes, your statement is correct.

A. Understood.

Q. You do not dispute that, do you?

A. I have no reason to.

Q. No.

It is also correct, is it not, that there was no capital injection into Royal Mail Group Limited in the period from 2013 to 2021, was there?

A. I believe that is correct.

Q. We can go through the financial statements, but having the fun of looking at the issue of equity capital value and showing that it is the same is probably not necessary in the light of that answer.

A. Sure.

Q. Thank you.

Now, I know you are not here as -- you are certainly not putting yourself forward as giving evidence on the law, but there is something I do want to pick up here. You are aware that the test we are considering is whether the claimant, Royal Mail Group Limited, suffered actual loss. You do understand that that is the test we

are assessing here; correct?
A. I think so, yes.
Q. Yes.
You are putting forward a measure, the WACC, which refers to what you say are debt costs and equity costs, correct?
A. Correct.
Q. But if there is no injection of equity, there are no equity costs in the relevant period, are there?
A. So that is why I, in my report, talk about retained earnings. You will be aware Mr Delamer and I had an exchange about the cost of retained earnings.
Q. Right.
Just as a general proposition, if you are a profitable company and you do not take any -- there is no equity injection, would you expect that your retained earnings would just grow in normal circumstances or does it depend on the level of investment that you are making?
A. It depends on factors such as the level of investment.
Q. Level of investment.
So you do not happen to know whether or not Sainsbury's, for example, has significant retained earnings?
A. I do not know about Sainsbury's specifically. I know of

other companies that do not pay dividends and that do either grow their earnings or make investments out of retained earnings.

Q. So unless your profits exactly match your investments, then just as an accounting matter, the difference would essentially be treated as retained earnings; is that in very loose terms correct?

A. So I am not an accountant. I definitely cannot speak to the way in which accounts would be prepared, but I think generally you are saying the right thing.

Q. Generally the right thing.

You are aware that in other cases where these issues have come up that there had been comment on whether or not a company had raised equity capital or there was an equity injection was material to whether or not the weighted average cost of capital would be relevant; are you aware of that?

A. So, as an economist, I have some peripheral awareness, but I would not say that I have gone through case law and understood the legal points.

Q. Right, I will leave that. I think that can be one for submission in due course.

Now, I should say, we say that, in the absence of dividends, the absence of an equity injection, it really is the end of the issue on weighted average cost of capital, but let us go to this point about retained earnings.

You suggest I think that retained earnings form part of the cost of equity and incur a cost of equity; is that right?

A. That would be the orthodox economics textbook position.

Q. Well, let us see about that.

Mr Jeavons' witness statement, if we could go to that, {D/IC7/42}, please.

THE EPE OPERATOR: There is some confidential information in this.

MR BEARD: I think that one is going to be okay. Can you just pop it up on to the screen briefly? It is 19.2, so page 42 I think. It is fine. Thank you. Yes, it is document references, but thank you for checking.

So Mr Jeavons tries to maintain the same position you do, that equity financing for a company may take the form of either equity injection or retained earnings:

"An equity injection is where new shares are issued [none here], increasing the share capital of the company, which can then be utilised by the company as finance. Retained earnings are the company's net income left over for the business after it has paid out any dividends [which we have dealt with] to the shareholders, which is retained in the business and used as finance."

So he is saying retained earnings are monies that can be used by the business to invest in essence; correct?

A. Yes.

Q. Yes.

"However, retained earnings form part of the shareholders' equity and do still incur a cost of equity. This is because the equity investor is sacrificing the opportunity to invest those retained earnings on other opportunities in the expectation of obtaining a return in the future ..."

So the reason he refers to there being a cost of equity is because essentially he is saying that there is an opportunity cost to the equity investor; that is correct?

A. That is what he is saying, yes.

Q. You agree with that as the characterisation, do you not?

A. I do, for reasons that again I can explain if you would like me to.

Q. No, I just wanted you to check whether you agreed.

But, I mean, what Mr Jeavons is there saying is that there is a cost to the equity investor but it is not a cost to the claimant, is it?

A. So, as an economist, my answer to that question is that the cost to the shareholder is mirrored as a cost to the company. I think in my expert reports I have quoted from the economics and corporate finance literature to really describe essentially two sides of the same coin here.

Q. So you are saying that, even though the situation is that an equity investor may face an opportunity cost, that should be treated as a cost to the claimant? That is your position?

A. As an economist, we have a concept of the cost of capital or the cost of equity, in which the opportunity cost borne by the shareholder is mirrored as a cost to the company.

Q. But what we are talking about when we talk about the opportunity cost of an investor is the cost to the investor of not being able to invest those monies in alternative investments going into the future?

A. That is correct.

Q. Yes. So we are not talking about actual losses, are we? We are talking about potential future opportunities being foregone; correct?

A. We are talking about an opportunity cost, that is right.

Q. Yes, but that is a future opportunity being foregone necessarily?

A. It is a contemporaneous opportunity. So that if the money is occupied in a particular company, it cannot be simultaneously invested elsewhere.

Q. So the point is that the equity investor who might have liked to have a chunk of those retain earnings to invest elsewhere is not able to do so; correct?

A. That is right.

Q. So that equity investor cannot take them off and say, "Well, actually, rather than Royal Mail, I would rather stick this in Apple because I think I would get a better return on that"; correct?

A. Yes, or just generally put it across the stock market and --

Q. Yes, sorry, I am certainly not operating as an investment adviser, Mr Earwaker. I would like to stress that for all concerned.

But the point is that it is the opportunity cost for the investor, is it not?

A. That is where the story starts, yes. I think, in my reports, I try to then explain why that is a cost of equity.

Q. Well, what you try to explain, I think, in your reports, is why, for the purposes of the weighted average cost of capital calculation, one treats -- one might, in certain circumstances, treat equity investor opportunity costs from an economic point of view as being translated

across to a company. But you are always, in those circumstances, talking about the future, are you not?
A. I am talking about the present and the future, yes.
Q. Yes, the opportunity being lost now for the future?
A. Being lost now and in the future.
Q. But what you are not talking about is any actual loss being incurred by the claimant, because the claimant in this case has those retained earnings and could invest them itself, could it not?
A. So that is the heart of why I think Mr Delamer and I could not agree on this particular issue. So, again, I can explain that if you would like me to.
Q. Let us come on to your explanation in a moment, but again, would you mind just answering the question I posed: the claimant has the retained earnings and is able to invest them; correct?
A. In a general sense, yes.
Q. Yes, and if it is able to invest them, then it can gain the benefits of those investments or risk the losses, of course?
A. Yes.
Q. Yes.
A. We have not talked about the overcharge yet. Obviously the overcharge prevents you from investing the monies and --

Q. I am sorry, I am just dealing with the concept of the retained --
A. (Overspeaking - inaudible).
Q. I will come back to the overcharge in a moment.
A. Sure.
Q. But I think the point I am making here is, if you have retained earnings, you can invest them, you can invest them short term, long term, there are a range of things that you could do, subject always to a legislative government constraint on what you can do with monies?
A. Understood.
Q. Yes.
A. Yes.
Q. Yes.
Therefore, if your retained earnings were lower than they might otherwise be, so this is in a situation where there is no -- so in circumstances where, because of a putative overcharge, your retained earnings are lower, what you would be losing is the ability to invest those monies in short or long-term investments or other investments; correct, as the claimant?
A. That is one perspective that you could take, yes. That is I think where we get to in these alternative scenarios that we describe in our expert reports.
Q. Well, the reason I say that is, in the real world, the

claimant has retained earnings. In the real world, if those retained earnings are lower than they otherwise would have been, what the claimant has lost is the ability to invest those lost monies, is it not?
A. What you are saying is factually correct.
Q. Yes, and that is the actual loss to the claimant in relation to these monies?
A. So that is not what I would agree with, no, because I, again, see the cost of equity in a way that I think perhaps you do not see.
Q. I certainly do not see it as an actual loss for the purposes of the claimant, Mr Earwaker. I think we can agree on that. What I was just testing is, if you have retained earnings, as someone like the claimant, and those retained earnings are lower, so that you cannot invest the missing money --
A. Yes.
Q. -- then what you are losing is the return that you would have gained on those investments of the missing money; correct?
A. So that -- I apologise. Questions like this make me feel quite uncomfortable because it does not tell the complete story. So what you are saying is correct, but I feel like I am not answering the question properly if I give yes or no answers.

Q. But it is correct what I have said?
A. What you say is correct.
Q. Yes, so those are the actual losses.
Now, you are obviously very concerned to explain further that there is an internalised further approach that can be taken here. Am I understanding correctly?
A. So, I am happy to go where you would like me to go, but what we have not talked about yet is the concept that when you take money from investors and when you have not yet paid them back there is a cost of equity.
Q. Right. Now, let us just be clear: there was no equity injection by the government?
A. Correct.
Q. So they have not taken any money from the government at all, have they?
A. Correct.
Q. What we are talking about are monies that have been generated by the claimant and put into retained earnings; correct?
A. Up until 2013, yes.
Q. Yes, okay. I am happy to go with that.
So in those circumstances, these are not monies that are taken from investors; these are retained earnings that the claimant is entitled to invest; correct?
A. That is one way of looking at things.

Q. But that is the right way of looking at things in terms of the reality of the situation, is it not, Mr Earwaker?
A. Only if you wish to ignore this concept of the cost of equity.
THE CHAIRMAN: I think we need to give Mr Earwaker an opportunity to explain what he clearly wants to explain.
MR BEARD: I am very happy for him to explain. He is itching to do so and we are going to come on to some further questions --
THE CHAIRMAN: Well, I think it is only fair that he does so.
MR BEARD: Well, let him do so.
A. I am not itching. It is just --
THE CHAIRMAN: No, no, if you are looking at it in a different way, I think you should explain to us what that way is.
A. So, I am an economist and I am trained as an expert in corporate finance, and the world that I come from, we see the opportunity cost borne by the shareholder that we have been talking about. But the literature that I have read into over 25 years is very clear that it is important to recognise that the cost, if you like, borne by the shareholder is also a cost that is relevant and that matters to the company.
So in my second expert report, I took the trouble to

spend a day in the library pulling off various textbooks and just making sure that I understood correctly what the consensus was in the world of economists, and they draw a clear mirror image across to the opportunity cost borne by shareholders through to the cost to the company.

THE CHAIRMAN: Is that the same costs?

A. So it is the same percentage number, yes, so ...

MR BEARD: Let us just test that. You actually say it mattered, you say it "matters to the company" was what you just said.

A. Yes.

Q. Is really what you are saying that, if you are a company and you wanted to get equity investment, the level of return you would need to offer to attract that equity investment would be at a certain level; is that how you are thinking about it?

A. So that is sort of where the story might begin, yes.

Q. That is where the story might begin. But that is to do with a situation where you are talking about potentially attracting equity finance in.

If you are in a situation as we are here, where you are not drawing in equity finance, then although, as a matter of theory, these things could matter for raising equity, in this situation it is not a real cost,

is it?
A. So I think probably what we are not talking about here is the way in which the value of the company can be affected by what it does with the shareholder money that it receives. So the reason why there is this corporate finance literature, the reason why people are very keen to stress that there is a cost to equity is that the value of the company can change, either in a positive way or a negative way, depending on whether shareholder money, either in the form of equity injection or retained earnings, is used in a responsible and appropriate way.
Q. So if you are dissolute with your retained earnings, people are going to treat the company as less valuable; is that broadly one aspect of what you are saying?
A. I think that is why it matters. You picked up the words "why does it matter". I think it matters to a company that they do not put themselves in a -- it matters to a company that it does not destroy value, it does not needlessly give shareholders a return that is far below the opportunity cost.
Q. But again, we are in the territory of giving investors returns so it is not far below the opportunity cost, because otherwise you will not be able to raise the equity.

A. Sure. So all I can do is I can explain as an economist how we look at things. We have the concept that this is something that is relevant and matters to the company.

Q. So if, from your point of view in corporate finance terms, this matters for the characterisation of investment analysis, for example, and therefore those are the circumstances where you particularly mirror these ideas of cost between shareholder and company, I think one of the things you are, fairly, not saying is that we can carry that concept across to the issue of actual loss in relation to the situation of this claimant in relation to an overcharge. I think you are distinguishing the two situations, am I correct?

A. I am sorry, I am not sure I understand the question.

Q. Well, I think we agree that the -- or you, I think, said you understood that the test we are considering here is whether or not there is an actual loss to this claimant from the putative overcharge that it has suffered in relation to the purchase of trucks.

A. Understood.

Q. Okay? So in simple terms, the case being put against us is: we, Royal Mail Group Limited, paid more for trucks than we should have done.

A. Okay.

Q. Now, that claim is recognised as being something that can be the subject to a claim for loss before this tribunal, which is what we have spent several weeks discussing. What we are now discussing though is, if that additional sum of money is suffered as a loss by Royal Mail Group Limited, does it also suffer damage because, if it had not paid those monies, it could have earned more? That is the test that we are really focused on here because that is actual loss. Do you see that?

A. I understand the perspective that you have. I am not a lawyer, so I ...

Q. Right.

THE CHAIRMAN: Would this be fair to say, that you are looking at it in terms of how one would value the company, or the claimant companies, and this would be taken into account in terms of valuing a company?

A. In part. What I want to do or what economists want to do is dissuade anybody from the notion that equity, once received, is free money or a free source of funding and that it does not matter what you do with that money once you have taken it into a company. So I think that is again one of the areas where Mr Delamer and I disagree, about whether equity is free money, free funding, or whether it has an ongoing cost.

The other thing I think I was probably striving for in my expert report was to think about when monies can be paid at different points in time, when a company will care or when a company will be indifferent about when it receives a particular payment.

Perhaps if I can give you an example. For example, if at the end of these proceedings you were to decide that Royal Mail was owed £100 million, to give a very round number, I think the view that I am hearing is that Royal Mail should be indifferent as to when that £100 million is paid, whether it is paid here in 2022 or it is paid in 2032. I think, in real life, the company is not indifferent as to whether it gets the sum of money now or whether it gets the sum of money in many years time, and it is not indifferent as to the rate at which that amount of money rolls up in terms of interest or equivalent.

I am trying to get at what would be the appropriate amount with which to roll over a sum of money which has been taken from a company and then is repaid at a later date.

MR BEARD: I would like to be clear, that is not our case at all. I think that is fairly clear. I think what we are talking about are measures of assessment of damage. Mr Earwaker has very plainly, just there, articulated the position that his concern is that injections of equity should not be treated as free money and that that drives the observations that he is making. Well, that may well be true, I will leave that for cross-examination of Mr Delamer, if there are disputes about it. But we have already traversed the issue that there were no equity injections involved at this time and therefore, in those circumstances, there is a danger that all of the questioning that I am about to embark on may be entirely otiose.

I am conscious of the time. I wonder if now might be a good moment and I might do some -- think about some filleting.

THE CHAIRMAN: All right, great.

We will have a ten-minute break now, Mr Earwaker. You may know that you are not able to speak -- whilst you are in the witness box, you are not able to anybody about the case --

A. I understand.

THE CHAIRMAN: -- so please refrain from doing so. Thank you.

(3.16 pm)

(A short break)

(3.28 pm)

MR BEARD: We are going to move on to a couple of other topics, but just to pick up one issue in relation to

retained earnings. Just to be clear, although you are not an accountant, I think you recognise that the retained earnings are not reported as a cost in any of the reports or accounts of Royal Mail; correct?
A. That is my understanding, yes.
Q. Yes.
So one of the things you say in your reports is that somehow Royal Mail Group internalised the WACC within its business, and you refer to that in your first report. You suggest that that is important for these questions about whether it should be used as a relevant metric for the assessment of interest. You say -- if we go to your first report at {E/IC9/18}.
THE EPE OPERATOR: There is a little bit of confidential information in there.
MR BEARD: Yes, do not worry, that is great. Thanks for the warning, but that one is fine.
You say:
"Mr Jeavons' witness statement, along with the separate witness statement provided by Ms Bradshaw, makes it clear to me that Royal Mail's management have throughout the relevant period recognised the cost of its capital as an important cost item."
I am going to work through that in a bit more detail in a moment. But can I just pause there. The claim

period we are talking about began in 1997, and Royal Mail Group Limited was actually The Post Office corporation at that time. Do you remember that?
A. Okay.
Q. Yes.
But it did not even start to use the WACC for even investment appraisal purposes until 2002; you know that?
A. That may be right, yes.
Q. That may be right.
Well, let us just have a quick look at that because you cite Ms Bradshaw's statement. Can we go to that at {D/IC2/13}, please? If we just go down to 5.10:
"As explained above, The Post Office had not yet identified its WACC in February 1999. I am not able to recall exactly when and how the first WACC estimate came to be calculated, and I understand from BCLP [that is lawyers] that Royal Mail has not been able to identify a document which records this. However, The Post Office's Accounting and Performance ... Policies Manual for 2000-01 ... does identify a 9% WACC ... in that it records the following."
Then, if we just go over the page {D/IC2/13}, then it refers to a WACC.
"Although this document does not address how the WACC was to be used in an investment appraisal context,

it suggests that matters had progressed since the meeting I had attended the previous year. The use of the WACC in an investment appraisal context was subsequently explained in the new Investment Policy for 2002 ..."

Which she then goes on to talk about.

Just going back to your statement -- your first report, 3.5, if we could, so that is {E/IC9/18} again:

"... It [is] clear to me ..."

From Mr Jeavons' witness statement and the separate witness statement of Ms Bradshaw:

"... that Royal Mail's management have throughout the relevant period recognised the cost of its capital [to be] an important cost item".

I mean, it is certainly not the WACC that was important to it, given that they had not even calculated it until 2000/2001; correct?

A. Yes, I think that throughout the relevant period, it is just clumsy drafting that -- but I --

Q. Understood.

If we stay there, going through some of the points you make in 3.5. The first point you refer to is the operation of the market economy operator principle. Fun though it would be to have a set of questions on the law of state aid, I am going to pass over that for the moment.

Let us go to (b). So you say:

"Royal Mail has consistently applied investment appraisal policies which generally ... permit the business to draw on investor capital only when it can be demonstrated (via use of a 'hurdle rate') ... returns to investment exceed the investor cost of capital."

So what you are saying there, and I think this is what Ms Bradshaw was referring to, is that a hurdle rate for investment appraisal will be used by the business with the funds that it holds; correct?

A. Yes, I am paraphrasing, but I read -- when I saw Ms Bradshaw's statement.

Q. Right, but here you are -- this is under the heading "Use ... of the WACC Within Royal Mail". What you are saying is that the WACC is the cost of capital measure that was used for investment appraisal as a hurdle rate; correct?

A. That was my understanding --

Q. That was your understanding.

A. -- from Ms Bradshaw's evidence, yes.

Q. Then, you see in (c):

"Royal Mail has subjected the estimate of its cost of capital, and hence its hurdle rate, to periodic review and adjustment."

So that is the same issue, but just saying it is reviewed from time to time, so (b) and (c) go together; correct?
A. I think so, yes.
Q. Yes.
Now, are you aware that when the case was originally pleaded, Royal Mail Group actually included a pleading of foregone investments based on the WACC as a hurdle rate?
A. I saw that in the strike-through of the statement of claim.
Q. You are aware that that whole claim based on hurdle rate has gone?
A. I am, yes.
Q. Yes.
Then, if we go to subparagraph (d):
"Royal Mail has recognised that under- [and] over-estimating the cost of capital would have adverse consequences."
Here, I think what you are saying and what you are drawing on in relation to this investment appraisal approach is the idea that, if a measure of cost of capital is set too low as a hurdle rate, then investments might proceed which, from an economic point of view, you might consider inefficient. On the other

hand, if it is set too high, investments would not be undertaken that could be efficient for the company; correct?
A. That is correct.
Q. Yes. So again, it is all to do with this hurdle rate for investment appraisal; correct?
A. That is what I am trying to capture in this summary, yes.
Q. Yes. Yes. Thank you.
Could we now go to Mr Delamer's third report, paragraph 66? So this is {E/IC72/49}. So this is the section -- I know you will have read all of this, Mr Earwaker. You no doubt have much greater familiarity with Mr Delamer's report than I do, or even possibly than Mr Delamer does. Everyone is concerned about reading everybody else's report, I am sure.
Here, he is explaining that he has compared the actual returns historically generated by Royal Mail Group on investments with the weighted average cost of capital. You understand the exercise he is undertaking?
A. I do, yes.
Q. Yes.
I think you understand also that his assessment shows that Royal Mail Group's actual returns were significantly below the WACC as you were calculating it;

correct?

A. That was what Mr Delamer's purported to show, yes.

Q. Yes.

Now, there is some confidential information that I just wanted to show you here. Rather than moving straight into confidential, just for this bit, so we can stay in open, we have got some hard copies to assist the tribunal. (Handed).

These are all on Opus as well.

I am really sorry, might I have one as well? Sorry, just to make sure. I realised I had been too generous with them! Thank you.

So just for your note, this is actually sort of further on through this section, but I am not going to ask the Opus operator to move it down, so we are just continuing down. If you can imagine the page scrolling up, we will go back to a rather more manual approach to it all.

If we just go over to figure 10, most of this is not confidential, but just out of an abundance of caution. Now, again, you will be familiar with this, but this is Mr Delamer's actual historical evolution of the claimant's returns using different metrics. The four, which I am not going to go through in detail, but it is a pre-tax ROCE, return on capital employed.

A. Okay.
Q. Post tax, pre-tax return on assets and post-tax version, and that is how you get the various coloured lines. So that is the assessment he is carrying out. I am not asking you to agree to that, but you understand what is going on --
A. I understand the analysis, yes.
Q. Yes. Those are the plots across time.
Then, what we do if we go over the page {E/IC72/53}, is see figure 11, which is where Mr Delamer has looked at the claimants' WACC rates of return as estimated by you versus the historical average returns, using the different metrics. We saw on the previous page that some of the returns were low and negative; there were some spikes in 2013, around then. I am not going to get into the detail of the level of them because it is confidential, but you see that those numbers are effectively averaged on the right-hand side in the four blue bars. Can you see those averages?
A. I do, yes.
Q. Then there is the comparison with three versions of a WACC. The Earwaker vanilla WACC is a particular plain flavour of WACC, is that fair?
A. It is probably not worth spending our time on, but it ignores tax as a concept, yes.

Q. It is a strange term that economists have adopted for normal and unpolluted, is it not? Their ice cream choices are very orthodox I think!

Then we have got some tax-oriented comparisons as well. So what we are seeing there is Mr Delamer putting forward a comparison of the actual returns with the cost of capital you calculated and some variants on it. Now, just to be clear, you did not carry out any sort of calculation of the actual returns by Royal Mail Group Limited over the period, did you?

A. No, I did not.

Q. No.

Now, in your second report at 3.32, so if we could just go on to {E/IC32/20}, this is where I think in your report you say that -- I am paraphrasing to some extent -- that Royal Mail Group Limited's actual returns are irrelevant to the assessment. Is that -- am I broadly capturing what you are doing here?

A. Broadly, yes, that is right.

Q. Yes.

Here, you talk about how -- in 3.33, you talk about how returns on assets metric is not directly comparable to the WACC, and you say that it is calculated as a return to equity holders expressed as a percentage of total gross assets, and that WACC is different because

it is a measure of returns to both equity holders and lenders; correct?
A. That is right.
Q. Yes.
But the return on capital employed, that does measure returns to both lenders and equity holders, does it not?
A. Not in the way that Mr Delamer went on to calculate it in his third expert report. I still have some issues with those calculations.
Q. Right, so you have some issues with the precise way in which Mr Delamer has calculated the return on capital employed for these --
A. In figure 10 and figure 11 that you have just showed me, yes, I do.
Q. Just to be clear, just going back to the basic question, return on capital employed does measure returns to both lenders and equity holders; correct?
A. If it is properly calculated, it could, yes.
Q. Yes, it could.
Your concern about Mr Delamer's calculation is that it does not properly calculate returns to equity holders; is that what you are saying?
A. I still have some issues with the denominator that he uses in the return on capital employed calculation.

Q. Right. Well, that is a matter that I think in due course Mr Delamer will be cross-examined in relation to, but we say that he has carried out a sensible comparison in relation to these matters and we have clarified that you have not carried out any alternative.

Let us just go to 3.34, you say there:

"... the WACC, by construction, is an ex ante (ie forward-looking) expected rate of return."

I think we have discussed that to some extent. You there say also it is:

"... [a] near certainty that outturn returns will either fall short or exceed the cost of capital ..."

In a way this illustrates the point that we have already canvassed. What you are doing with the WACC is looking at a forward-looking appraisal, the cost of capital; what we are interested in is actual losses that have occurred in the past. Therefore, it is understandable, is it not, that you can have essentially your economic world discussing the significance of the WACC, and our world of trying to assess actual loss approaching these things differently? I think you recognise that?

A. That has become apparent I think through the conversation we have had so far, yes.

Q. Yes. Yes, thank you.

So, if we go to 3.35 {E/IC32/20}, this is where you say:

"Even if Mr Delamer had reported figures for return on capital employed on a basis ... comparable to the WACC, and even if this comparison showed that outturn returns were below the cost of capital, this would simply indicate that risks generally crystallised in an unfavourable way for Royal Mail between 1997 and 2020 [in other words as you put it] ... the revenue that Royal Mail was able to generate from its day-to-day operations fell short of its costs ..."

So if you are hypothesising that this cost of equity that forms part of the weighted average cost of capital really is a cost to Royal Mail, what you are saying is, day to day, actually they did not make the same sort of returns that they would have hoped to in order to recover those putative costs; correct?

A. That is right. Royal Mail had some pretty serious headwinds during the period that we are looking at here, so it did not -- I think even if I were to correct Mr Delamer's numbers, I would not see a return that was equal to the cost of capital.

Q. No, you would actually see a return that was way lower, would you not?

A. Whether it is way lower or lower, I am not sure, but it

would not surprise me if it were --
Q. No.
A. -- a noticeable difference, yes.
Q. Yes.
Sorry, Mr Bourke reminds me, when you say cost of capital, you do mean the WACC there, do you not?
A. I do mean the WACC, yes.
Q. Yes. Thank you.
Sorry, I should finish off in the "ie":
"... that the revenue that Royal Mail was able to generate from its day-to-day operations fell short of its costs, inclusive of the ex ante cost of capital [which is the point we were just discussing], meaning that shareholders lost money on the capital they put into the company."
So we are back into the issue that you are identifying, that there would be a loss to shareholders in your hypothetical, but because of the way that you look at this, economically, you treat that as a cost to the company as well?
A. A loss --
Q. Yes.
A. -- of value, yes.
Q. I see.
Now, I just want to move on to a slightly different

topic in relation to the WACC.
A. Okay.
Q. If we could go to your third report, 2.35, this is {E/IC60/19}. So this is under the heading in your report "Relevance of returns on short-term investments vs cost of debt". You say here:

"In the case of shareholder-owned, profit-focused company, it does not make sense to think that Royal Mail would currently be sitting on a bigger amount of short-term investments were it not for the Defendants' overcharging. Instead, it is much more logical to assume that short-term investments would remain sized to business needs."

Just picking up a couple of points here. When you say "shareholder-owned, profit-focused companies", are you meaning private companies as opposed to state owned?
A. I am -- so the context for this section is I am talking about Royal Mail as it has been since 2014.
Q. Right.
A. I am describing Royal Mail as a shareholder-owned profit-focused company.
Q. Okay, but here, when you say that, are you hypothesising a sort of optimally efficient company in terms of its financing?

A. I am talking about a company who is there trying to earn the maximum profit for shareholders, a profit-maximising company if you will.
Q. Profit-maximising, profit-focused.
In essence, you would expect that the short-term investments would be, as you say, calibrated to business needs, but that -- when you say "business needs", you are meaning that that would be the optimally efficient pool of short-term investments for any particular business; is that what you are hypothesising there?
A. So I am saying that, particularly having read Mr Jeavons' evidence --
Q. Right.
A. -- in common with other profit-maximising companies, the amount of short-term investments that the business has on hand is intended to be suitable for the risks that they face and the issues they may encounter, and no more than is necessary.
Q. Okay. Right. Well, we will maybe come on to take that in context when we come to some of the numbers.
Now, in the pleadings, I probably do not need to take you to them, there is an estimation of the WACC which you will have seen in the re-re-re-amended particulars of claim. I will not take you to it, only because it is confidential. If you want to go to it,

that is fine.
A. No, that is fine.
Q. But you carried out a new calculation of the WACC, did you not, for your reports?
A. That is right. I thought it was important to give an independent calculation of the WACC.
Q. Yes, that is fine.
Now, I am not going to go through all the details, but we picked up earlier that the capital asset pricing model had three elements: risk-free rate, expected market return and the beta; yes?
A. That is right.
Q. Yes.
If we could just go to your first report at {E/IC9/41}, please, and if we could just pick it up just down the page, at 6.41. You say here:
"Royal Mail plc, [which is] the ultimate parent company … [of the Claimant], has been listed on the London stock market since 2013. The business of Royal Mail (the Claimant) has historically been by far the largest business within the Royal Mail plc group of companies. I am therefore able to use eight years of share price data for Royal Mail plc ... to estimate Royal Mail's beta notwithstanding that [these are two] separate corporate entities."

So, as I understand what you are doing is, for the purposes of the capital asset pricing model, you are taking the parent's beta and applying it to the claimant?
A. As the best available comparator or proxy company that I have, yes.
Q. You have said that is an appropriate comparator. Now, you do not have share price data before 2013. I think that is clear; correct?
A. That is right.
Q. Yes, so you do not have any information to feed into this capital asset pricing model, essentially for the first 16 years of the claim; correct?
A. I have to make an extrapolation or assumptions.
Q. Yes, and you say this at 6.47, if we could just go down {E/IC9/43}?
THE EPE OPERATOR: There is one line of confidential on there.
MR BEARD: That is fine, thank you for checking. It is great having a confidentiality cop!
THE CHAIRMAN: I do not really understand why things like that should be --
MR BEARD: No, this is part of the problem. I think what has happened is there has been an automated --
THE CHAIRMAN: Any reference to -- right.

MR BEARD: Yes, and protests were lodged early on in the process about that means of identifying confidentiality, but we are where we are with it. We are trying to cooperate.

THE CHAIRMAN: The footnote is not confidential.

MR BEARD: No. The ironies here we leave to one side. The fact that only the main text was searched.

THE CHAIRMAN: Not really a matter for this witness anyway.

MR BEARD: No, it is certainly not -- this does not lie with Mr Earwaker, that one we can definitely be clear on. Let us pass swiftly over the way in which those things have been dealt with by BCLP.

So, here, you are recognising that you do not have the share price so you cannot directly compute a beta value for the early years. You do not think the figure of 0.8 should be -- you have no reason to think 0.8 is not a reasonable proxy.

"I note that the basic nature of Royal Mail's core business has not changed fundamentally in the past 25 years and I find it difficult to identify any compelling reasons why the sensitivity of Royal Mail's profits to systematic risk factors, like growth in UK [GDP], should have changed in a material way during this period."

So you are saying there is a sort of constancy,

therefore you can read backwards to some extent?
A. As the best available assumption I had at the time.
Q. I understand the approach of trying to take the best available, but what you do not recognise here is that there was a very significant change in the business after 2012, because Royal Mail Group Limited was separated from Post Office Limited, was it not?
A. Yes.
Q. Post Office Limited was a vastly different business from Royal Mail Group Limited, was it not?
A. That may be right.
Q. You know that Post Office Limited took very significant losses during the period 1999 to 2011?
A. Yes.
Q. So, Royal Mail Group Limited with Post Office Limited would have had a very different risk profile when it was part of the same group with Post Office Limited up until 2012, would it not?
A. I would need to think about that. So the way that CAPM asks us to think about risks is very specific. It asks us to think about the exposure to the systematic risks in the economy. So I would need to think about that.
Q. Okay, you would need to think about that, but you did not think about that for this report?
A. So, I did not, because I was able to use some other

cross-checks in order to make sure that the overall WACC calculation that I was coming up with was reasonable.
Q. But you did not actually think about how the capital asset pricing model risk profile analysis would work in relation to Post Office Limited?
A. Not specifically to Post Office Limited, no.
Q. No.
I think you recognise that a government-owned business might function rather differently from a privately owned business?
A. That may be right.
Q. Yes.
So, of course, Royal Mail Group Limited was privatised in 2013 and therefore there are very significant dangers about extrapolating backwards?
A. So, again, that is where the cross-checks became important. I was able to cross-check to Postcomm's contemporaneous estimate of Royal Mail's beta during the time.
Q. You say that gave you enough confidence in relation to these matters?
A. Then Mr Delamer has also looked at this and come up with some very similar numbers for the cost of equity and the WACC as well.
Q. The Postcomm beta only covers the period from 2006 to

2010, does it not?
A. It covers the period 2006 to 2010 in the sense that was the beta that was used to fix Royal Mail's profit entitlement for that period, but, obviously, that calculation would have been in probably late 2005 and it would have been a backward-looking calculation.
Q. I think the point I am putting to you is that, given that whilst noble endeavours to use the best possible comparisons may be worthy, actually we have a series of issues here that create real problems and doubts about the ability to extrapolate backwards from 2013.
A. I think we have a good handle on what Royal Mail's cost of capital, cost of equity was, historically. Mr Delamer had his own attempt at calculating a WACC and we came within spitting distance of each other. My WACC was very similar to the Postcomm WACC, so I feel quite confident that we have assessed what the WACC was.
Q. I am not going to even begin to toy with the image of two economic experts being within spitting distance in relation to WACC calculations, but for the moment we will --
MR RIDYARD: In these calculations we are interested in how -- are we interested in how the profits of these companies vary over the cycle against the other returns on other investments? So it is not that we are

saying -- it is not that you have to say it is identical to what happened before, but it is just the profile of the returns, how that compares with the profile of returns you would get on other equity investments?
A. That is right. We were essentially looking for the covariance --
MR RIDYARD: The covariance, yes.
A. -- between the firm's returns and the returns that were available on the market as a whole.
MR RIDYARD: Yes. So it is a very -- as you say, it is a very specific aspect that you are looking at. When you are saying they are comparable, you are not saying they are comparable in every respect, but you are just saying how does this company vary over the business cycle compared to other equity investments?
A. Exactly, so thinking about that co-variance specifically, because that is what CAPM requires us to focus on.
MR RIDYARD: Yes.
MR BEARD: (Inaudible). I wanted to highlight the particular issues that arise here, but obviously the CAPM model has particular parameters of comparison. As Mr Earwaker has rightly said, there has been a discussion between the experts in relation to it. The key issue is that none of this shows actual losses in

relation to what we are talking about.

What I now wanted to move on to was actually cost of debt.

A. Okay.

Q. So leave the pleasures of equity and move to debt.

Now, here, in fact, as I understand it, between you and Mr Delamer, there has been a significant degree of agreement on the interest rates that Royal Mail Group Limited has historically paid on its borrowings for the period 1997 to 2013, in general terms; is that right?

A. In our discussions we tried to push things that were not material to the side and focus really on the material matters of disagreement.

Q. Yes.

Now, I think that although there was a large measure of agreement, there are a couple of issues that I think we need to explore where there is a disagreement.

Now, I have tried to stay out of confidential material so far. I think, at this point, I am about to go into one or two specific materials on debt instruments and so on, where Royal Mail have indicated that they want them to be treated as confidential, and I do not think I can sensibly dance round those in terms of references?

THE CHAIRMAN: So we need to go into private?

MR BEARD: I think we need to go into private unfortunately.

THE CHAIRMAN: Anyone who is --

MR BEARD: Yes, essentially, clearing out people -- I think mostly everyone here is actually going to be able to stay, but I think it has to be confidential. So I do not know if there are any non-ring members. No, it is lawyers and economists and economists' support.

(Pause for discussion re transcript)

(The session continued in private)

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