IN THE COMPETITION APPEAL TRIBUNAL 1517/11/7/22

Salisbury Square House
8 Salisbury Square
London EC4Y 8AP

Monday 18th November- Friday 20th December 2024

Before:

The Honourable Justice Michael Green
Ben Tidswell
Professor Michael Waterson

Merchant Interchange Fee Umbrella Proceedings

A P P E A R AN C E S

Sonia Tolaney KC, Matthew Cook KC, Owain Draper & Daniel Benedyk on behalf of Mastercard (Instructed by Jones Day and Freshfields Bruckhaus Deringer LLP)

Daniel Jowell KC, Jessica Boyd KC, Isabel Buchanan, Ava Mayer & Aislinn Kelly-Lyth on behalf of Visa (Instructed by Linklaters LLP and Milbank LLP)

Kieron Beal KC, Philip Woolfe KC, Oscar Schonfeld, & Reuben Andrews on behalf of the SSH Claimants (Instructed by Scott+Scott UK LLP and Stephenson Harwood LLP)

Mark Simpson KC, Jack Williams & Alastair Holder Ross on behalf of Walter Merricks CBE (Instructed by Willkie Farr & Gallagher (UK) LLP)

Tuesday, 3 December 2024

(10.30 am)

MR JUSTIN COOMBS (continued)

Cross-examination by MR COOK (continued)

THE CHAIRMAN: Good morning.

Good morning, Mr Coombs.

THE WITNESS: Morning.

MR COOK: Good morning, Mr Coombs. We are now turning to automotive fuels. Now, you do two pieces of analysis here, firstly, in relation to petrol and, secondly, in relation to diesel. Then you produce a weighted average of your pass-on based on the pair of those results. That is right, is it not?

A. Yes.

Q. You will be pleased to hear that this is one sector where I am not going to be disputing that you have chosen indexes which match well, that the RPI and PPI indexes are very closely aligned because they deal with essentially exactly the same product. So that is what I am not criticising here.

If we can turn to the modelling choices that you have made. If we go to your first report at page 154 {RC-F/10/154}, we can see that at 4.48(b) in relation to -- this one is in relation to your petrol model, that you do not include a time trend. If we go over the page to 155 {RC-F/10/155}, you see in relation to your diesel model, and it is paragraph 4.53(b), you decide that you should include a time trend in relation to the model for diesel.

Now, if we can go back to pages 152 and 153 {RC-F/10/152-153}, if we can show them both on the same screen, please, we can see, looking at the trends for petrol and diesel, they both follow a fairly -- as you might expect, they follow a similar trend over the periods of analysis, do they not? Similar spikes at similar times, similar shape and pattern. So there really is not a justification for analysing two very different or two -- sorry -- not a justification for analysing two measures which move very much in harmony using a team trend for one but not the other.

It just seems that -- I mean, you are picking and choosing which models you apply on which occasions, are you not?

A. Well, in this case, the reason for including it in one case and not in the other is that it is statistically significant in one case and not in the other, and also actually including it does not make -- does not make much difference to the results. It does not make a material change, anyway.

Q. The other adjustment you make, if we go to page 156

{RC-F/10/156}, is you see paragraph -- at the top of the page, 4.53(d) which is there. You say you:

"... also include two month-specific dummy variables for March 1999 and October 2000 ... to control for the large percentage changes in the diesel retail price that occurred in those two months."

Then if we go to the bottom of the page, we can see footnote 516, you say that:

"Failing to control for these two percentage changes in the diesel retail price results in the model for diesel failing the test for heteroskedasticity."

Now, in terms of what you are doing there -- I mean, firstly, you are only doing this -- if we can go back to figures 8 and 9, so pages 152 and 153 {RC-F/10/152-153}, you are choosing dummy variables to include in diesel but not petrol, in circumstances where there is very much a similar pattern of movement in prices in relation to the two series, but, perhaps more significantly, when we look at the diesel data, there is nothing exceptional about the price movements at that point.

There are, as Ms Webster analyses in her report, similar or much larger price movements both up and down throughout the time period, so how is it you seized on those two particular months as being ones that you should identify as being dummy variables for?

A. Well, because I suppose it is exactly what it says here in the report, which is that I find that if I do not control for them, then I have a problem of heteroskedasticity. I do what is the usual practice in this situation, which is to try and identify what is causing that, and identify it is being caused by these two particular outlier observations, so I then control for them. That is a fairly standard approach in these sort of situations.
Q. Yes, but the problem is they are not outlier situations because there is nothing unusual about them. As Ms Webster says, there are lots of other months that also have similar or much larger price movements up or down, so why did you pick on these two particular ones?
A. Because they are the ones that seem to be causing this problem for heteroskedasticity. It is what I find when I investigate the data.
Q. So what you are doing is you have gone through and tried excluding other ones, different ones, is that what has happened?
A. Yes.
Q. What difference does that make to your results?
A. Well, I find it is these two particular observations which are causing the problem.
Q. So you have done a series of other adjustments with

different months to see what different it makes?
A. To be honest, I cannot remember exactly what other approaches I took, but the point is that I identified that these two observations were causing this problem and therefore I controlled for them.
Q. But, I mean, if we look at figure 9, which is the diesel one, I mean, there are a whole lot of significant movements throughout the period, so it must have been something that you were going through, or members of your team went through, trying all sorts of different permutations to find ones that worked?
A. Yes. But as I say, I cannot remember exactly what permutations were tried, but, yes, you are right, I would have looked at other possible sources of heteroskedasticity as well and identified that this was the cause.
Q. What type of differences did that make to some of your pass-on estimates? If you tried lots of different permutations, did that produce different results?
A. Well, to be honest, I cannot remember exactly what permutations were tried and what impact that had on the results. The point is I am reporting here what I found to be the cause of the heteroskedasticity and how I controlled for it.
Q. So basically you have gone through and found a way of

identifying particular months that, if you dummy for them, then the numbers give you a number that you feel you can rely on, not putting forward the ones where the data simply does not give a reliable result?
A. What I am doing is I am putting forward what is the most robust estimate.
Q. But you have not identified a sort of a coherent reason for picking those particular months rather than other months that have larger price rises. So you have left some of those larger price rises, similar price rises, in the analysis, and they are dummying just for these two. So, you know, this is entirely a product of selecting to try and find a way to make the data work, is it not?
A. Well, it is trying to find what is the most robust estimate, and this is the approach I used to find the most robust estimate.
Q. It is not robust if you have -- if you are selectively excluding data without any sort of logical reason for it, apart from: this makes the model work at the end of the process?
A. Well, I would disagree. I would say this is a way to analyse the data in order to identify, you know, is there a problem, and if there is a problem what is causing that problem, and how does one adjust for that

problem. This is, as I say, not an unusual approach. This is a fairly standard approach to dealing with this sort of problem.

Q. Well --

A. In my experience.

Q. There is a difference if you have identified some external consistent pattern, like with a price rise every January that you need to take account of, but that is different from coming to the end of the process and then selectively just trying to find data points that you need to exclude in order to get a number that will satisfy your client?

A. Well, it is a common problem in econometric analysis to find that there are, you know, particular anomalies in the data which cause particular problems and then adjusting for them. As I say, this is the approach that is quite standard in terms of trying to produce a robust econometric analysis.

Q. In terms of --

PROFESSOR WATERSON: Can I just ask in connection with this: I mean, one of the reasons why one might do this is because you identify particular, say, extraneous events that might have caused the aberrant observations. Were there extraneous events of that sort?

A. No. So I did not have any information as to what might be causing these anomalies.

PROFESSOR WATERSON: Right. So it obviously involved some experimentation then?

A. Yes.

PROFESSOR WATERSON: Thank you.

MR COOK: Just looking at overall what you are doing in relation to automotive fuels, I mean, this is in practice just a pass-on analysis for COGS in the context of a business where the wholesale cost of fuel is the vast majority of a fuel retailer's costs?

A. Yes.

Q. So without knowing how fuel retailers took account of their other costs in their pricing during the Merricks claim period, this really tells the Tribunal nothing about the rate of pass-on of other costs, does it?

A. No, it is -- well, it is the point that you just mentioned, that the vast majority of their costs are the costs of fuel, and this is a common approach in the literature when analysing pass-on of costs in the fuel sector to do this type of analysis.

Q. But in the literature, that tends to be because you are analysing how far the wholesale price of fuel is passed on?

A. Yes. So obviously this has been used as a -- as with all of these sectors, and all the analysis that

everybody has done in this case, this is a proxy for the MSC. So one is using a pass-on of the fuel costs here as a proxy for estimating the pass-on of the MSC.
Q. But without any information on what fuel retailers actually did in terms of how they took account of that in their pricing?
A. In terms of evidence directly from the retailers, no, this is an analysis of the pass-on based on comparing prices with COGS.
Q. The next sector we are moving on to then is hotels. So in relation to hotels in terms of previous studies, you have not found any relevant UK studies, have you, which -- and the two you have found are US studies which relate to room tax, so you do not get very much from previous studies in this context, do you?
A. Could we go to the relevant page, please?
Q. Yes, absolutely. Previous studies. If we go to your first report, page 207 {RC-F/10/207}.
A. From memory, what you say sounds right, but I would like to just look at what it actually says.
Q. Can we go a couple of pages earlier {RC-F/10/205}.
The only studies you come up -- you identify are US studies, both relate to government-imposed room taxes, pass-on rates are 70 to 85%, and they are both time periods outside the Merricks claim period?

A. That is correct, yes.
Q. So I suggest it is not much you get from previous studies in this context?
A. No. They are less relevant than some of the previous studies from some of other sectors, I would agree with that, yes.
Q. In terms again of the analysis you do here, this is based on comparing a CPI index for accommodation services to the average weekly earnings data for accommodation and food services activities. That is right, is it not?
A. So it is the -- so the wage measure is accommodation and food services, yes.
Q. Accommodation and food services includes restaurants, takeaways, pubs and clubs, does it not?
A. Yes.
Q. In fact, the same labour measure you use for restaurants?
A. Yes.
Q. Now, Ms Webster's analysis indicates that food services account for around three times the output of accommodation services, so that measure is likely to be heavily weighted towards restaurant employees, not hotel employees?
A. Yes. I think it is the point that I made yesterday,

which is the sort of -- the assumption here is that we have a labour market where people who work in hotels and people who work in restaurants are drawn from, and the same sort of people who might be recruited to work in a hotel might be recruited to work in a restaurant. That is sort of the assumption here.

MR COOK: Sir, I understand the live stream is not working.

THE CHAIRMAN: Right. (Pause)

Shall we just carry on and see if we can sort it out?

MR COOK: Absolutely, sir.

At paragraph 4.193, page 209 of this report {RC-F/10/209}, you address the percentage of costs incurred by hotels which consist of -- it is on the previous page, 4.193. Yes {RC-F/10/207}.

At 4.193, it says:

"Industry reports indicate that payroll costs represent around 50% of UK hotels' [over the page] expenses related to rooms and are generally their largest cost category."

So the data you are looking at in terms of some sort of labour measure is a proxy which at best relates to half of room expenses. Is that right?

A. Yes.

Q. So it is still nothing like the total costs proxy that

you would like to use?
A. No, it is -- but it is the best evidence that was available.
Q. Now, if we turn to the modelling choices that you have made. This is one where you use a time trend, and the effect of doing so -- if you have not done so, that means your analysis fails the bounds test, is that right?
A. Yes.
Q. I mean, all of this shows just how dependent all of your modelling is on the modelling choices you make, would you agree?
A. Well, in this particular case, if I do not include the time trend you are correct, the model fails the bounds test. It also produces a much higher estimate of pass-on.
Q. (Inaudible) reliable?
A. Yes.
Q. Now, in terms of the pass-on rate, if we go to 4.204, which will be on two pages. No, on {RC-F/10/211}. So again the familiar process you do here, retailer mark-up, and in relation to that you say:
"... average markup for the hotels sector which was 21.0% ..."
But if we look at footnote 683, which is at the

bottom of the page, we see:

"The markup is calculated from the SUT data for the industry 'I55 Accommodation services' ..."

Now, we looked at this yesterday, but if we can go back to page 207 {RC-F/10/207}, paragraph 4.192, you concluded -- this is two pages earlier -- that the data available from the SUT is insufficient to allow you to reliably estimate the different costs for the hotel sector.

So you are using a mark-up from the SUT table, having just concluded that the SUT data is not reliable in the context of the hotel sector since it includes information in relation to other activities. We will see the rest of that explanation in 4.192.

A. So, yes, well, the point is explained in the footnote, in the sense that I do not have a better way of estimating the mark-up.

So I think the point here, maybe just to clarify what the difference is, is that what the ONS defines here is what they call accommodation services, but their definition of accommodation services is both the hotel selling a room and also the hotel selling a meal in the restaurant in the hotel. So it means that when you are looking at this data, it is a mixture of the two.

So that is a problem in the sense that the -- what

I am trying to do is I am trying to isolate accommodation services, because I have a separate sector we discussed yesterday that looks at restaurants. So it is a problem, I agree with you it is a problem, and it is a problem that meant I did not rely on that data in order to try and estimate what proportion of costs were made up of labour, or I did not purely rely on that, I should say, so I looked for external evidence which suggested that the share was about 50%.

If you look at the evidence actually from the ONS on the cost share, which would be the -- so this would be 4.9 -- 4.193 on page 208 {RC-F/10/208}, so you find there that the share is, on average, 40%. Now, we can go to it if you want, but that is actually quite similar to the share in restaurants.

So although I had been cautious in not relying on this evidence, it might actually not be that different between hotels and restaurants, given that the share is quite similar across the two. So I have -- that is why I have also looked at external sources, but it all points towards the same sort of thing, which is that labour is about half the cost.

Now, when it comes to calculating the mark-up, again, this is the only evidence I have, so in some ways it is arguably imperfect, because it covers both

accommodation and the food that is sold in hotels, but it is the only evidence I have, so that is what I used to estimate the mark-up.
Q. It is weighted higher by including restaurants where you have calculated a lower margin -- sorry, that is a bad question.
It is weighted by including other -- it is including food in there and hotels, you simply do not know what the hotel number would be?
A. No.
Q. In terms of temporal extrapolation, once again you do the bit where you remove five years of data. If we can go to Ms Webster's reply report {RC-G/13/74}, you see once again that Ms Webster has tested your methodology to see whether it gives a different picture if you look more closely at the Merricks claim period, and we can see that, when you look at the Merricks claim period, rather than your figure of 55.8%, it ends up with a number which is more like 40% or so.
A. Yes. Well, this is -- I mean, we covered this yesterday. The problem is that then you are removing about half the data from the analysis and therefore producing a much less reliable estimate.
Q. Well, the problem is you say you are producing a less reliable estimate; what you are producing is an estimate

which is much more related to the Merricks claim period?
A. Well, there is -- I mean, maybe this is a matter of judgment, but my judgment would be that it is a much less reliable estimate because you are excluding about half the data, therefore I do not rely on it. Instead, I use the estimate using the full period for which I have data, and then consider whether that -- it is appropriate to use that for the full Merricks period.
Q. Well, when you have evidence indicating that the Merricks period was consistently rather lower, that is an indication it is not appropriate to rely on an average that might be weighted up by -- higher in the later period, lower in the earlier period?
A. Well, it does not actually indicate that it is consistently lower, because if you actually look at what Ms Webster does, and I am not saying that one should rely on these estimates for the reasons I have just set out, but hypothetically, if one were to rely on these estimates, actually there is only one that is lower than the estimate I rely on. All of the others that she produces are actually higher.
So her analysis does not show that for the Merricks period you would consistently get a lower pass-on rate; it actually tends to suggest that for most of her sensitivities you would end up with a higher pass-on

rate.

Q. I mean, what this illustrates more than anything else in hotels is the enormous uncertainty that one gets with any of these estimates, because actually if you make relatively limited adjustments to what period of data you are looking at, you get radically different results?

A. Well, I am saying if you make a limited adjustment, which is the words that you just used, then you get the result that I quote in my report, which is it goes up -- the elasticity goes up from 0.42 to 0.53. If you make more ambitious adjustments by excluding half the data, then you get much larger changes, which is not surprising. If you reduce the dataset so radically, you would expect that you would get much less reliable and uncertain results.

Q. But even in relation to looking at the purple, red and light green, which are excluding three years, four years and five years, again you get quite a significant spread between the numbers. It is an indication of how unreliable this kind of analysis is, that relatively small changes in time periods you are looking at do actually result in quite significantly different numbers?

A. Well, I am not quite sure whether your comment is focused on this sector or is a comment more generally

about the analysis --
Q. In particular hotels at this point.
A. Yes, so -- because, I mean, for other sectors you do not actually -- you know, in many other sectors, in fact most sectors, you do not get these sort of dramatic changes. But in terms of the hotel sector, as I say, well, I think I am repeating myself, but, you know, first of all I do not think one should rely on estimates where you have excluded half the data from the analysis, and, secondly, there is only one of these sensitivities that actually leads to a lower pass-on rate. So if one were to rely on them, the conclusion would be that the pass-on rate that I rely on may be too low.
Q. In looking at all of this, ultimately all you have done is look at a measure of labour costs, and, again, which we saw, was about 50% of room costs. This tells the Tribunal nothing about the pass-on rate in relation to non-room operating costs, does it?
A. Well, it tells one about the pass-on rate for the largest cost component here, which represents about half of the cost of the business. That is what it tells one. Now, I suppose the question is: well, what is the alternative that one would do here? So the alternative is that one would have to use merchant data, and there you would have the issue that you would then be rather

relying on data that covers the entire hotel sector, you would be relying on data just from one merchant in this sector, so those are the choices one has to make.

PROFESSOR WATERSON: Can I just check, if you remind me. So when one looks at these different periods, this is to do with the econometric estimate of the pass-on rate of the elasticity, as we talk about, between costs and prices?

A. Yes.

PROFESSOR WATERSON: Do you also adjust the other component, the share component, when moving to different periods, or is that always the same?

A. That is always the same, yes.

PROFESSOR WATERSON: Right. So would it not make sense, though, to adjust the share component if you are looking at a different period?

A. Yes, one could do that, and therefore, rather than looking at the impact on the elasticity, one would be looking at the impact on the pass-on rate, if you then adjusted the mark-up as well.

PROFESSOR WATERSON: Yes. Thank you.

MR COOK: But on that, there is not data on share components in this sector, not reliable data?

A. No.

Q. Turning then to the next sector, which is vehicle sales and services, or basically it is vehicle services overall which includes the selling of vehicles and the servicing of vehicles and also car rental, car leasing.

A. Yes.

Q. Now, in relation to this, what you do is you analyse -- and this is where we get into sort of what you might call mixed analysis. You do a bit of public data and a bit of merchant data. That was not meant to sound derogatory, it is just that we are now moving on from areas where -- the first six sectors we have done are pure public data; this is now something where you do some public data mixed with some merchant data, so it is just explaining where we are in the sort of, you know, the order of what analysis you do.

A. Yes, maybe if I can put it in my own words, what I would say is this is a sector where I have both -- I have public data for part of the sector, for vehicle services, but not suitable public data for the other main part, which is vehicle sales. So I used public data for the part where I do have suitable public data, which is vehicle services, and then I analysed merchant data that is available for this sector as well.

Q. Let us start with the public data analysis you do which is in relation to vehicle services, and that is basically repair and maintenance of vehicles.

A. It is repair and maintenance and part sales.

Q. Part sales, yes. That is done by ... repairing and part sales. So that is done by comparing the CPI index for the maintenance repair of personal vehicles to the average weekly earnings for retail trade and repairs. So, again, you are just looking simply at a labour measure in this context?
A. Yes.
Q. So while you rightly picked me up that it includes part sales, you are basically not including any costs in relation to parts in this analysis?
A. No. I mean, we can go to it, but I looked at what the likely component would be and found that labour costs is likely -- seems likely to be the majority. Or, well, maybe I should be more careful here. It is probably about 50% or maybe a bit more than 50% of the cost in this sector or sub-sector.
Q. The AWE, Average Weekly Earnings, data you used is the same data you used in relation to food and drink returns?
A. It is, yes, retail and repairs.
Q. Retail and repairs. So that is basically the whole -- all retail sectors of the UK economy and vehicle repair and maintenance is the measure of Average Weekly Earnings for that very broad ...
A. Yes.

Q. I mean, that measure is not going to give you any kind of indication of the pay of a skilled worker that is involved in vehicle maintenance and repair, somebody who is a trained mechanic?
A. No. Well, I mean, just to be clear, there is not a narrower measure available. It is the narrowest measure that was available.
Q. My question was: looking at an average which includes people who stack shelves is not going to give you an idea of what you pay a skilled mechanic, is it?
A. No. But I think the labour costs here might not just be the skilled mechanic, it might be other staff as well.
Q. But a large part of that is going to be people who are skilled, trained, and therefore command higher wages in this sector?
A. Yes, but I think it is -- part of the measure of labour costs here is also going to include those sort of people as well, so it is obviously an average.
Q. It is obviously an average for a much wider sector which has completely different levels of skilled, semi-skilled, untrained staff in it?
A. Well, I do not know whether it is correct to say that it is a completely different mix of people. I would just say that it is a measure for a wider set of businesses than just the repair of motor vehicles, that is correct,

yes.

Q. Now, if we turn to the modelling choices you have made in this context, the key choice you make is to include -- if we go to paragraph 4.351(d) on page 253 {RC-F/10/253}, at subparagraph (d) you explain that one of the key choices you make is including:

"... a dummy variable to control for the large increases in vehicle service prices in January of the following years ..."

Then you identify I think it is ten years where you include dummy variables for the January. So this appears to be an industry where prices go up annually in January, is that right?

A. Yes, or at least in some Januarys.

Q. It is understandable that you want to take account of that kind of annual increase in prices. Why have you only included half the Januarys and not the other half?

A. Well, actually if you go -- if you look at the graph on page 252 {RC-F/10/252}, I mean, it can be quite difficult, given the large number of data points, but you can see that in some years there is a very clear increase in January of some years but not in others.

Q. I mean, what kind of test did you use to identify what was a significant test -- what was a significant price increase and what was not?

A. Well, essentially I looked at the data to identify where were the situations where there was an obvious increase in price in January.
Q. What constitutes an obvious increase? What kind of threshold were you using?
A. Well, I suppose I was using my judgment, looking at the data.
Q. If we go to paragraph -- page 254 {RC-F/10/254}, we can see that the effect of this is that, with the model you have come up with, at subparagraph (c), the model passes the bounds test at 5%. But while it passes the test for serial correlation, is does not pass the test for heteroskedasticity. So with those January dummies, it does not pass the test, so basically the bounds test result is at that point unreliable, and that is the conclusion, is it not?
A. Well, in terms of the -- in terms of the result that is reported, yes.
Q. Now, you then make the point, in subparagraph (d), that:

"If individual dummy variables for January in 2003-2006, 2009-2011 and 2014 are included in the above model, then it [does pass] the test for heteroskedasticity, as well as the test for serial correlation and the bounds test, and produces a ... pass-on elasticity of 0.77."

If we can possibly have up on the screen page 253 and 254 together, please {RC-F/10/253-254}.

I want to compare with you subparagraph (d) at 4.351 and subparagraph (d) at paragraph 4.353, the differences between the January dummies you include in your main model, which you say was based on your judgment about which ones were the larger increases, and then the individual dummies that you suggest including alternatively.

You say -- the main analysis of the difference is you suggest that 2001 and 2002 should be dummies in the main model. They are not in your alternative model. January 2008 you suggest should be a dummy in your main model, it is not in your alternative, and in the main model you do not have January 2009 as a dummy but you do in the alternative. So that is one you have not identified as having a significant price increase, but now you do include it in your alternative model, is that right?

A. Yes.

Q. I mean, can you explain -- that must mean that what you have done is just gone out and basically just played with the data to try and find out which -- moving which Januarys in and out of the data gives you a result which can pass the tests. Is that what has happened?

A. Well, what I am trying to do is I am trying to -- so I identify that there is a problem with heteroskedasticity, and then I try to see what is causing that problem, and so I identify which are the particular January events that are causing that problem. Then I find out that, well, if you control for those, this is what happens to the estimate.

PROFESSOR WATERSON: Sorry to break in again, but you said you want to find out what is causing the problem. But actually you are not finding out what is causing the problem, are you, you are finding out which observations are causing the problem?

A. Yes, that is correct.

MR COOK: Including finding observations, January 2009, that you had not identified as having a significant increase in prices?

A. Yes, but -- well, as I -- well, I would agree with the way that Professor Waterson has put it. What I am trying to do is I am trying to find out what observations are causing the problem.

Q. You do not have any principal basis for doing this. This is just -- you know, you have identified which ones are largest, and then you include one that is not one of the largest. Re-include, ie do not dummy for, a couple you have identified as larger ones. There is no

principle behind this at all, is there?
A. The principle behind it is that there are large price increases in January, and what I am trying to do is I am trying to identify which of those large price increases are causing this problem of heteroskedasticity and what happens if you control for that.
Q. The impact, as we see in 4.353(d), the impact of doing -- of your alternative set of choices is it brings the pass-on elasticity down by about 12.5%.
A. Yes.
Q. One-eighth. Why are you reporting -- why have you reported a number which does not pass the test for heteroskedasticity, and then you have not -- you do not rely upon a number which does and is somewhat lower?
A. Well, I think -- so I have reported what the alternative result is. I suppose if you are saying would it be better to rely on the alternative result, I think you could be right, yes, maybe it would be appropriate to rely on the alternative result. It would have some impact on the pass-on estimate. It would reduce this particular estimate by about 12.5%.
Q. But I am just -- what made you put forward a number that essentially was not statistically reliable when you had an alternative one which at least passed the tests, albeit it that it was based on selectively removing data

to make it pass the tests? What was your thinking at the time?
A. Well, I cannot recall what my thinking was at the time, but I think I am -- well, I think I am agreeing with you, Mr Cook, in the sense that if you are saying would it be better to rely on the estimate of 0.77 rather than 0.88, then, yes, I am agreeing with you it would be better to do that. If you are asking me why did I not do that in my reports, I cannot remember exactly why -- the logic as to why I put it this way round, but I did report both results in my report.
Q. Both of them are selectively based on not some principle basis for trying to control for data, but simply finding a way to make the model produce a result which passes the test?
A. Well, I would say -- I would not put it that way. I would put it that what I am trying to do is I am trying to identify if there are anomalies in the data that need to be controlled for.
Q. You say anomalies in the data. I mean, that is just -- you know, you have no reason to think any of the data is wrong, ie it does not accurately reflect prices, so, you know, that is just simply those are the prices that were being charged. There is equally no reason to think that there was some external factor other than the standard

annual price increase which is applying here. So this is part of the data which shows how prices and costs have evolved over time?

A. Well, what you are seeing -- so these incidents, these price increases all happen in January, so they are -- they are a seasonal effect. So this is -- I mean, this is a common situation with this data, the same thing we find in other datasets that I have analysed, that there is seasonality, in the sense that there is something that happens at a particular month or particular months in a year, and it is standard approach, when you identify that, to try and control for these sort of effects.

Q. If you control for seasonality, that might explain controlling for all of them but not some of them, and certainly not selectively picking and choosing the ones you want to control for, based on whether it makes the numbers work at the end of it?

A. Yes. But in this particular case what you find is that, you know, it is not a uniform effect across the years. You find it happens in some years and not in others. That is what I am trying to identify here.

THE CHAIRMAN: I am just slightly confused as to why you do the -- you use the dummy variables, as you say in 4.353(d), why you are going through that process if you

are not actually using the figure at the end of the day, you are using the less reliable figure, is that right?
A. Yes.
THE CHAIRMAN: Is that what you are doing?
A. Well, I think, to be honest, on reflection, I think probably I should have used the 0.77, I think that is the more reliable estimate. So, on reflection, I should have used that instead, yes.
THE CHAIRMAN: Right.
MR COOK: I mean, what made it unattractive is it was lower?
A. Well, I think the point is that the effect is quite -- the difference between the two is quite small, so I think that is the -- that was the point I was trying to make here, that the difference between the two is quite small. So you say it is 12.5%, but, as we also sort of identify, this is not the estimate that I rely on for the whole sector, this is part of the estimate that I rely on for the whole sector. So this difference actually gets diluted once you include the estimates that I make with merchant data.
But I think -- I mean, the point I was just trying to make in the report is to say the difference between the two is relatively small.
Q. If we go --
A. But if you want me --

THE CHAIRMAN: -- explain that, I think, in the report, as to why you were choosing the 0.88 rather than the 0.77?

A. Yes. Well, I think what I am saying to you now, sir, is that, on reflection, I probably should have used the 0.77, rather than the 0.88.

THE CHAIRMAN: Yes. I understand.

MR COOK: If we go up to paragraph 4.353(b) now, we can see that refers to the adjustment coefficient, it says it is 1%:

"... indicating that the price of vehicle services ... adjusts by approximately 1% each month towards the long-run equilibrium following a deviation."

So that is another one where that means essentially it would take over 200 months. Well, 90% of the pass-on you calculated would be reflected in prices, so this kind of incremental reduction over time. So that is the duration of the Merricks claim period. So, again, why did you not explain that the pass-on levels you were referring to would take the entire Merricks claim period to work their way through?

A. No -- well, I agree, I did not sort of make that calculation and set that out here. I just reported that -- what the adjustment coefficient is and that it is very small.

Q. I mean, that has a key impact, does it not, on the

extent to which retail prices paid by consumers were actually affected during the Merricks claim period? If one looks at the first five years or so, the effect on consumers, even based on your numbers, would be very minimal, would it not?
A. If you -- well, in this particular case, for this particular sector, yes.
Q. So why were you not -- why is that not taken into account in -- because you just apply the headline number for each one of these sectors to the entire potential overcharge within that sector, but what you are actually saying is a large part of that overcharge does not get passed on during the course of the Merricks claim period, until much later on in the Merricks claim period.
A. Well, I think what you are raising here then raises the question about whether -- when did the elevated MIF start? Did it start at the beginning of the Merricks claim period or was it already there before the start of the Merricks claim period? So I think the answer to your question depends on those facts.
Q. Okay, but Mr Merricks is not suing and cannot sue in relation to MIFs that existed before 1992, so we are not worried about whether something that happened in 1989 has an effect on the Merricks claim period. That is not

part of the claim.

A. It is not part of the claim, but it is relevant to the question that you are raising.

Q. But in terms of the overcharges that you are looking at, you know, it is important to know when they actually got passed through, and therefore what extent(?) they had on retail prices, and in this context you are saying for the first few years almost nothing?

A. Well, as I say, from an economic perspective -- maybe from a legal perspective you may say things are looked at differently, but from an economic perspective I would want to look at what was the previous situation in the previous years in terms of the level of the MIF.

Q. In terms of how you come to calculate your adjustments here, if we go to page 254 {RC-F/10/254}, we see the familiar steps of retailer mark-up adjustment, and this is another one where you use -- we see at footnote 780 at the bottom of the page an adjustment from SUT data, here in relation to the wholesale and retail trade and repair of motor vehicles and motorcycles.

Again, that is data which, if we go to page 251 {RC-F/10/251}, paragraph 342, where you just said you do not consider it:

"I consider the data from the SUT insufficient to allow [you] to reliably estimate the shares of different costs ..."

In turn, therefore, insufficient to allow you to reliably estimate the margin. That is because, as you go on to explain, it covers the wholesale and retail trade, ie sales of both new and second-hand motor vehicles, as well as maintenance and repair services.

So, again, you are using data which you have just said is not a reliable source for this -- in this context, are you not?

A. Well, the point is that it is the best evidence that I have, the best evidence that I can use to calculate the mark-up, and I explain in the footnotes the limitations of the data.

Q. But you do not make clear in your report that you are making an adjustment which you know, you know, is unreliable, do you?

A. Well, I would not say it is unreliable, I would say it is the best information I have, and I explain in the footnote the limitations of it.

Q. Well, it is very unlikely that this combined measure ... Unless the margin on every single one of them -- sales of new cars, sales of second-hand cars and maintenance -- is exactly the same, it is almost certain that the average is going to be wrong, is it not?

A. Well, I think one of the -- so I think this raises a point. So obviously a lot of the questions that you are asking me are pointing out that there are imperfections in the data that is being relied on, and I do not think there is any argument about that. The data is not perfect, there are imperfections.

I think one of the questions that one then needs to ask oneself is, you know, does one expect there to be an inherent bias in the data because of these imperfections? Now, you know, I am not aware that there is any reason to expect an inherent bias in the data. It may be wrong, but I do not know which direction it is wrong. So as I say, I set out here the data that I have used and I have set out that there are limitations to the data, but I cannot really say any more than that.

Q. Again, this is just simply a question -- you are analysing simply labour, which is, as you say, 50% of the cost of vehicle maintenance services, and you do not have any information about how vehicle services companies actually treated other operating costs, such as MSCs, do you?

A. No.

Q. If we turn then to what you do next, which is look at Pendragon data. Now, some of this is confidential, so we may have to be a little bit careful in ensuring that we do not mention specific numbers, but very little of it is, so I hope, Mr Coombs, that we can go through it without trespassing on confidential information, so we can do it in open court, but if there are points you feel we do need to deal with, then that is something we have to deal with if we come to it, but I think we can do this without.

Now, in relation to vehicle services, you use Pendragon data for 2017 to 2024. That is all much more recent than the Merricks claim period, it is the period which was heavily impacted by the pandemic, is it not?

A. Yes. Well, I would say that is an issue with all of the merchant data that is available in this case, that it all covers a period after the Merricks claim period, and it all covers recent years, so it all covers the period of the pandemic.

Q. But this is the first time that you try and do the total cost analysis which you state in your report you consider the appropriate cost proxy for the MSC?

A. So, yes, when I am analysing merchant data, what I try to do is I try to use a measure of total costs.

Q. We saw in your report you say total cost is the appropriate cost proxy for MSC. So this is the first time you are trying to do what you consider to be the appropriate proxy?

A. Well, perhaps if I can break that down. So the starting point is that the MSC is a variable cost, and therefore what I am interested in is the pass-on of variable cost. The second point is that what am looking for is I am looking for the long-run pass-on rate, given the length of the Merricks claim period, and, in the long-run, costs which are fixed in the short-run become variable in the long-run.

So therefore when I am trying to analyse the pass-on rate, ideally what I want to do is I want to do an analysis on total costs, not because I think it is appropriate to analyse the pass-on rate of fixed costs, but simply because those fixed costs are likely to have become variable in the long-run, and therefore if one is looking in the long-run, it is appropriate to look at total costs.

Q. You also explain it is appropriate to look at operating costs, because you identify that a number of merchants seem to include MSCs in their operating costs?

A. Yes, but the reason for analysing total cost is the reason that I just explained.

Q. Now, Mr Coombs, I mean, we will come to see what analysis you actually did in relation to the Pendragon data, but, I mean, just for a moment, I mean, we discussed yesterday the different potential mechanisms for the pass-on of short-run marginal costs, the pass-on of fixed costs. Now, if you do a total costs analysis and that shows a pass-on rate of, say, 75%, that could mean all costs are passed on at 75%, so every single cost is 75% passed on, or it could mean, for example, that COGS are passed on at 100% but fixed costs are passed on at 50%. That will obviously only work -- those numbers will only work if there is a 50:50 split, which will give you then the average of 75.

So there is nothing in terms of the analysis which allows you to distinguish between the two scenarios, is there?

A. No, there is not. That is -- the bias in the results that you are suggesting is that then the result would be to underestimate the pass-on of variable costs.

Q. Well, only if -- well, yes, I mean, the pass-on of costs which are treated by that merchant as part of marginal costs?

A. Yes.

Q. I mean, the question of how exactly a cost is treated will then be quite relevant to which one of those categories it was in?

A. Well, I think what is relevant is how costs are passed on in the long-run. So we need to be careful about what we mean by how costs are passed on, because it is long-run mechanism that is relevant here.

Q. I think we are in danger over going over territory we went over yesterday, so I will move on to the next topic.

Let us look at what you have actually done in relation to your total costs analysis. You explain a key aspect of your approach at paragraph 4.365, on page 256 {RC-F/10/256}. Pendragon provided profit and loss statements containing information on operating costs for each segment:

"These costs are reported across segments and not at the product level."

You say you:

"... allocate the operating costs to each product based on that product's share on total direct costs in each month. That is, I assume that each product's share of operating costs is the same as its share of direct costs."

I mean, that approach makes no real sense at all in an industry in which -- where there will be some services which are purely labour, and some services -- ie with no direct cost, and some services which have a potentially quite significant direct cost, because they involve supplying a whole lot of parts. Would you agree?

A. Yes, this is a common problem -- well, it is a problem that people face all the time when you are trying to allocate overhead costs to a particular product, because from an economic perspective there is no uniquely correct way of doing that. So it is always -- there is always a choice of different approaches that can be used, and in this case the approach I used was to allocate on the basis of share of direct costs, and the reason for that was I felt that was the most appropriate method in this case. The obvious alternative is to allocate on the basis of revenues, but then that introduces a bit of a circularity in the analysis, because then your costs become sort of dependent on price in some way, which is a problem that we are trying to avoid here. So therefore I felt the more appropriate way was to allocate them based on cost.

Now, if you are saying, well, any allocation mechanism is imperfect, I would agree, any allocation mechanism is always imperfect. I just tried to use the one that I felt was most appropriate in this case.

Q. I mean, in this context, you are dealing with a situation where, to give you a scenario, I go into the garage with a puncture. Scenario 1, they find and fix puncture, so they charge me for an hour of labour for doing that. Scenario 2, exactly the same, go in with my puncture and they say, sorry, that is going to need replacing. So they replace the tyre, so they charge me for the tyre, plus an hour of time for checking and then replacing the tyre. So it is an hour of labour in each case, but in scenario 2 they charge me for the cost of the tyre as well.

I mean, your analysis will basically allocate operating costs to the second, because there is a tyre, but not operating costs to the first, even though the same labour element applies to both?

A. Yes. So what I am implicitly assuming here is that -- you have given an example. The more likely example is that the more expensive the part that is being replaced, the more labour that will be required to do that, and therefore there is going to be some correspondence between the two. That is the assumption that I am making.

Q. Yes, but, I mean, there are -- I mean, my understanding of the data is that -- perhaps you can comment on this -- a significant proportion of -- about 30% of Pendragon's activities have no direct costs associated with them, because they simply were services where the mechanic does the work without any requirement to buy direct costs. Is that a fair commentary?

A. Yes.

Q. So you are talking about a lot of activities that are time but not materials?

A. Yes.

Q. I mean, that is clearly not a sensible way of allocating the costs of the building, operating costs, when -- you know, merely based on a happenstance of whether a part is required as part of that process?

A. Well, I think I have already agreed with you that this is -- that it is always an imperfect science to allocate overheads to individual products, that is always the case, and I have used what I thought was the most appropriate way to allocate in this case, and it is the same approach that I use across all merchants.

Q. That is helpful. I mean, I will flag which one that is true of, but obviously I am going to ask you questions about it once, rather than duplicate them each time.

I mean, the other problem with this approach is if you apportion overheads by reference to direct costs, ie basically COGS, then you are actually not passing -- you are actually not testing whether there is pass-on of total costs. In practice, what you are doing is just scaling up COGS each time by margin. Whatever that is, if it is 20% each time, effectively you adjust -- all of the variation is coming from the COGS measure, which is then simply being scaled up each time by reference to overheads?

A. Well, no, that is not correct. I mean, I think there is -- in what you say there is some truth. So what I would agree with is that the size of COGS is obviously determining the allocation, so to some extent, you know, the allocation is being driven by changes in COGS, rather than changes in overheads, but it is not correct to say that it is just simply scaling up COGS.

The point is this: if you take -- if you take -- one extreme case is that overheads stay the same and COGS vary. So in that extreme case then what you say, Mr Cook, would be correct, that the only thing that is varying and driving the variation in total costs is COGS. But you can also think of the opposite extreme case, which is that there is a change in overheads but there is no change in COGS or no change in the share of COGS across different products. So in that case overheads have gone up but the share that is allocated, the shares have not changed.

So total costs will go up, but the thing that is driving the change in total costs is purely the change in overheads, because there has been no change in the share of COGS across segments.

I am not quite sure if I have ... I might have completely lost you there, sir.

PROFESSOR WATERSON: Yes, that raises an issue about whether

Pendragon has changed the number of dealerships it runs over the period, because my understanding is that car manufacturers will insist on what we might call a lavish dealership premises, which may cost £1-2 million to build, and therefore opening a new one is a significant amount of money?

A. Yes. Well, I suppose the point is that what I am doing is I have data on what the overhead costs are. I have not sort of investigated what is driving changes in overheads. But to the extent that overheads are changing, then that is going to change total costs. So to -- so it is not true to say that the only thing that is driving the change in costs here is changes in COGS, it is also being affected by changes in overheads costs.

PROFESSOR WATERSON: I agree.

MR COOK: If we can go to Mr Holt's twelfth report {RC-G/17/29}. I made the mistake of trying to paraphrase what Mr Holt says, and I should actually go to what Mr Holt says as being far more efficient.

In particular, it is paragraph 56, but if we go over the page to paragraph 56(b), you can see he says there:

"Mr Coombs allocates overheads on a per-unit basis proportionally to COGS per unit. As a result, the variation in his measure of overheads largely reflects variation in COGS."

I think that is the point you picked me up on. But that is right, is it not: basically the key driver, or the driver primarily will be variation in COGS. As you note, there is the potential for some aspect of overheads to be built into that, but it is -- the measure of overheads is largely reflecting variations in COGS?

A. I am not sure I agree with the word "largely", but I agree it is being influenced by the change in COGS.

Q. He says:

"There is, in [his] view, no reason why overheads per unit would generally be proportional to COGS. For example, this allocation implies that a t-shirt sold ... for £4, COGS would incur half as many overheads to sell a t-shirt with £8 COGS."

Then he says in paragraph 57:

"The consequence is that all the analysis [so yours among them] based on overheads rely on variation that does not reflect variation on overhead prices. In the best case scenario the pass-on implies by analysis will be likely significantly underestimated. However, in most cases the estimate are likely to be simply meaningless."

That is a fair description of what you result from this kind of allocation, is it not?

A. No. I think Mr Holt is sort of overstating the issue here. So -- well, firstly, there is no perfect way to allocate overheads, as I have said. Secondly, I think that this is the most appropriate way to do it because it avoids the bias that you introduce if you allocate based on revenues. Thirdly, I disagree with the idea that it means everything is being driven or is almost entirely being driven by a variation in COGS. I think what is happening is it is a combination of the two. So to the extent that overheads are varying, that is going to affect the analysis.

Now, it is true to say that that effect is somehow reduced by the fact that you are also reflecting variation in COGS as well, but it does not mean to say that all you are doing is measuring the variation in COGS, you are measuring the variation in overheads as well.

I think the other point I would agree with Mr Holt on is that to the extent that it introduces a bias, what this does is it introduces a downward bias. So it suggests that the estimated pass-on rate is possibly lower than the true estimate.

Q. Perhaps we can go to figure 25 in your report on page 258 {RC-F/10/258}. I think this is probably a confidential one, so ... but I do not think we are

going to be using any numbers that are confidential. The light blue line is operating costs, and we can see that that is, as we can see, probably say relatively smooth with a couple of small changes. Then direct costs is the dark blue line, which is a rather more jaggedy one. Sales revenues at the top, that is even more jaggedy. But looking at that, it is quite clear that the variation is likely to be much more driven by changes in COGS than it is by changes in overheads?
A. So for this particular merchant, there is more variation in COGS than there is variation in overheads. That is correct. But there is also -- it is not that there is no variation in overheads, there is variation in overheads as well.
Q. So Mr Holt is quite right to say that your approach is basically largely driven by changes in COGS, rather than overheads?
A. Well, for this particular merchant the variation will be driven more by the variation in COGS than the variation in overheads, that is correct.
Q. I mean, it is true to say in general that you would -- for most businesses you would expect that the costs of their inputs would probably change more than overheads which have a significant fixed element. I know "fixed" in this context does not mean does not change over time,

but, you know, a lot of things like rent will change in a -- will change more rarely and by less significant margins than changes in the supply of the cost of products?
A. I think that is probably true for most merchants. My recollection is that there is at least one merchant where that is not the case, but we might get to that.
Q. Were you being oblique because you were worried that was confidential?
A. Yes.
Q. I think we probably -- I think the name of a merchant is probably not going to be confidential in that context.
A. Yes, so, well, the merchant I am thinking of is WorldRemit. But anyway, that is my -- I am also being careful because that is my recollection, and we might want to check whether my recollection is correct when we get to look at that merchant, so I am saying no more than that at this stage.
Q. Okay. It is just helpful to know which merchant I need to look at for that point when we come to it. But you would agree for most merchants it is likely that COGS is going to be a lot more variable than operating expenses?
A. Yes.
Q. I have put the point to you about the consequences for your analysis.

In terms of what you do with the data you produce as a result of this, if we can go to page 261, paragraph 4.380 {RC-F/10/261}, you give a familiar retail and mark-up adjustment using Pendragon's actual data, which is confidential and we do not need to look at the numbers. Then in relation to the effective VAT rate, we can see there that you use actual VAT rates for Pendragon, rather than the economy-wide rate.

This confirms what I was putting to you yesterday, does it not, Mr Coombs, that you are actually not applying your economy-wide VAT rate to all sectors. As soon as you move into merchant data, you are applying actual rates based on merchant data, are you not?

A. Yes, that is correct, yes.

Q. Now, in terms of how far you can rely upon Pendragon data and read it back to any part of the Merricks claim period, if we look at 4.396 {RC-F/10/266}, you make the point, having considered how margins change over time, and you say at paragraph 4.396:

"Overall, although the pass-on rate I estimate for vehicle services ... using public data does not appear to be systematically biased upwards ... the evidence on markups suggests my analysis of public data may overestimate the pass-on rate for the early years of the Merricks claim period."

So that is another one of those sectors where you identify there may be an overestimate and an adjustment needs to be made, but you do not know how much.

But then in relation to the merchant data, which is the next section, if we look at paragraph 4.402, which is at page 267 {RC-F/10/267}, you reiterate the same point about the sector having become less competitive prior to -- or less competitive prior to 2000 -- it had become more competitive -- and then stable level of competition from 2000 onwards.

Again, you say that as a result, pass-on estimates for a later period may overestimate pass-on rates in the earlier pre-2000 period. So that is -- you make the same point as a starting point in relation to merchant data, but then you say, at paragraph 4.403, you suggest your analysis of Pendragon data is likely to underestimate pass-on rate across the period due to the inclusion of firm-specific costs in the analysis which you cannot disentangle from industry-wide costs in the merchant data. Then you note that the Pendragon results are significantly lower than the ones you get from the public data.

Now, in relation to firm-specific costs, I mean, you would not expect in a competitive market that a business is going to be able to continue operating profitably if

it has substantial firm-specific costs, would you?
A. Well, you would -- I do not agree with that, no. I think the point is that different firms will have different firm-specific costs, so it is not, you know, that one firm has a firm-specific cost and other firms do not, it is that all firms will have firm-specific costs, but they will incur these firm-specific costs at different points in time, and therefore that affects their ability to pass on those costs.
Q. I mean, these are -- when you talk about those, you are talking about somebody's rent goes up in year 1 and somebody else's rent goes up in year 2?
A. I am not just talking about rent. We could be talking about any type of cost.
Q. But if everyone is broadly incurring similar categories of costs or similar types of cost, the fact that they spend it on slightly different things is not actually go to alter whether they pass it on?
A. Well, no, I disagree, and I think all of the experts in this case, I think, have all expressed the same opinion, which is that you would expect that in a competitive market firm-specific costs are less likely to be passed on than market-wide cost. I think that is something that all the experts had agreed on, was my understanding.

Q. I mean, that would certainly be true if you had a firm that incurred a cost that was greater than anybody else. But if everyone else is incurring -- you know, everyone is going to have slightly different costs, because somebody decides to have a slightly nicer set of loos in their showroom, and somebody else has a slightly more expensive something else, but they will not spend money on all exactly the same thing. The end result though is broadly similar expenditure, the fact that it has been deployed in marginally different places in terms of how they have nice buildings or not is not going to alter pass-on, because basically everyone has incurred broadly similar category -- similar expenditure?
A. Well, I think you are confusing two different points here. So one is the point about whether they broadly have similar levels of cost, and then, secondly, is how they incur changes in those costs. So it may well be that they have broadly similar levels of costs, but it may be that they incur changes in those costs at different levels and at different points in time.
The second point is the point that is relevant for the calculation of pass-on.
Q. I mean, your analysis is that over time that does not really matter. If they are all incurring the same costs, the fact that they incur them at slightly

different times, your analysis is that that does not matter, I had understood?

A. Well, it does matter here, because what we are looking at is we are looking at a relatively short period of time. So what we are effectively estimating is a relatively short-term pass-on rate, and so therefore these differences are going to be relevant.

Q. So when you say "relatively short pass-on rate", you are looking here at -- the Pendragon data for vehicle services was 2017 to 2023?

A. Well, can we go to the table on page 260, table 72 {RC-F/10/260}, which we sort of skipped over.

So these are the actual results that I rely on. So if we look at the table, so there are three sets of results on the left and three sets of results on the right. So the three sets of results on the left are the results that include the full data period that Mr Cook has just described, so that means it includes the Covid period, and then I control for the Covid period with dummies for the relevant years.

The three results on the right are results which exclude the Covid period, so they only go up to 2019, so I think that means effectively we are looking at maybe three years of data, if I am correct, January 2017 to the end of '19, so that would be three years of data.

Now, one thing that Mr Cook skipped over is that the results that I actually rely on are the results on the right, not the results on the left. So the results on the right, which are actually slightly lower and therefore more conservative, but the point that is relevant here is that they -- because they exclude the Covid period, it is only three years of data and therefore is a relatively short period of time, so it is essentially a short-run pass-on rate, rather than a long-run pass-on rate that I am estimating.

Q. So in that case, consistent with your view that pass-on potentially takes place over a much longer period than a few years?

A. Yes. So you mentioned the fact that I say the estimate for Pendragon is likely to be an underestimate because it is capturing firm-specific as well as market-wide costs, so that is one reason why it is a potentially underestimate. Another reason why it is potentially an underestimate is because it is capturing a short-run pass-on rate, rather than a long-run pass-on rate.

Q. In relation to two of the three, so workshop -- it does not actually make any difference at all. Workshop is seven years. Then in relation to vehicles there is a very small effect, so it is minimal. It is only really parts actually that the shorter time period makes

a difference; is that right?
A. Sorry, I did not follow what you are saying.
Q. I am just observing. You said the ones you rely upon are the ones on the right, which are a shorter period, but the workshop is the same for both, so when you look at seven years' data you get the same number. For vehicle sales, a very small change, so the only one it actually makes a difference to is parts, part sales.
A. Sorry, I did not follow that. So the data starts -- unless I am very much mistaken, the data that we are looking at here starts in January 2017.
Q. Yes.
A. So if I am excluding the Covid period, it starts in January 2017 and ends in December 2019, so that is three years.
Q. What I was observing, though, is you said you are relying on the ones on the right, which are a shorter period, because when you look at the ones on the left, which are a longer period. Workshop, it does not make any difference to. Vehicles, it makes almost no difference in terms of elasticity, so you are looking at seven years -- sorry, you are looking at the period there. Then in relation to parts, that is the one it makes a difference to?
A. Yes, that is correct. Yes.

Q. So I was simply observing, in relation to two out of the three, there does not seem to be an effect between three years and seven years?
A. Yes. So the main effect is on parts, yes, I would agree with that.
Q. In terms of your --
THE CHAIRMAN: I do not know if you are coming to an end on Pendragon, but we need to take a break. How much longer will you be?
MR COOK: I have another ten minutes or five minutes on Pendragon.
THE CHAIRMAN: Maybe we ought to make take a break now.
Alright, a ten-minute break.
(11.48 am)
(Short Break)
(11.55 am end
MR COOK: Mr Coombs, before the break we were looking at your table 72 on page 260. If we can bring that back up {RC-F/10/260}. I think I was failing to be -- or we were failing to distinguish clearly enough in terms of data periods between the two categories.
So in relation we see to vehicle sales, the data was January 2019 to December 2023, so there were five years of data. Then your main assessment that you rely upon actually excludes data from January 2020

onwards. So for vehicles you end up with a number which is based on a single year of data, 2019?
A. That is correct, yes.
Q. Then in relation to parts and workshops, you have data for 2017 to December '23. So that is seven years. In relation to that, your primary number is based on excluding January 2020 onward which then give you the three years?
A. Yes.
Q. So, looking at vehicle sales, I mean, what you end up with therefore as your primary number is based on a single year of data for one merchant in 2019. I mean, that is really not providing any sensible basis to calculate what the pass-on rate would be for the entire sector in a period that starts 25 years earlier and ends nearly a decade earlier?
A. Well, the other -- well, as you say, there are two results here, and I also have the result using a longer period and that leads to a slightly higher pass-on rate. So I think using the shorter period is the more conservative estimate.
Q. Well, here it does not make very much difference because the results are very similar. My point was more, either way, you are looking at data which is 2019 onwards. 25 years after the beginning of the Merricks claim

period, a decade after the end. If you use the longer period, that is impacted by the pandemic, which you try and control for. But your preferred way of controlling for it is to exclude the data entirely. I suggest that is not a sensible way of trying to produce a number which is in any way reliable for the entire car sector for a period that goes back 25 years earlier.

A. Well, some of what you say I agree with but not everything. So I think you are making a point that I think I made, which is that when one uses merchant data, one problem with merchant data is the merchant data is only available for more recent years, and therefore that is one of the reasons why wherever possible I have used public data.

So despite the imperfections that we have spent the past day and a half discussing in the public data, the public data does at least cover the Merricks claim period or at least the majority of the Merricks claim period. The merchant data is only available for more recent years. So that is a disadvantage of using the merchant data.

Now, does that mean to say that we should completely ignore the merchant data and draw no conclusions from it? I would not go that far, particularly because there are some sectors or subsectors, and vehicle sales is one of them, where the public data simply is not suitable. So specifically for vehicle sales, the issue is that, as we all know, a very significant proportion of cars sold in the UK are imported and the data on the cost of imports is not available -- well, it is only available for more recent years. I cannot remember exactly what years, but for a period that is far too short to use in the analysis.

So in the case of vehicle sales, I took the view that it was not appropriate to analyse public data, because the match between prices and costs would just not be sufficient. So in the case of vehicle sales, I have relied on merchant data. I agree with Mr Cook that the merchant data is less than ideal in this situation, but the reality is it is the only thing we have.

PROFESSOR WATERSON: Just to understand this. So these are panel data for the merchant across the dealerships, if you like?

A. Yes. So -- well, for some merchants the approach is different. For some merchants it is purely a time series analysis.

PROFESSOR WATERSON: But this would have to be a panel in order for you to get significant results, given the short time period. So the results here are largely being driven by the cross-sectional variation, rather than the time series variation?

A. Yes. I mean, I think that -- well, let me expand on that. So, yes, it is a panel data analysis. The panel data is actually, in the case of vehicle sales, at the level of vehicle model and month is the sort of unit in the panel. There are fixed effects for the products, so control for variation across the products. So I would argue actually the variation that we are capturing is really the time series variation across all the different products in the panel. Does that make sense?

PROFESSOR WATERSON: Yes, I think so. But it does highlight the very short period that you are using, which is not -- I admit, it is not your fault, but really a very short period like that is not likely to give a very accurate result?

A. Yes. Well, I would agree with that. I would -- yes, as I have said, it is the only evidence that we have.

PROFESSOR WATERSON: Yes.

MR COOK: Just for your reference, it is page 250 of your report where you say the PPI for imported inputs was available from December 2008, so it would have been available from December 2008 to December 2019, so for an 11-year period, which you rejected as basically being not robust enough. Then what you end up using is data which is for one year for one merchant?

A. As Professor Waterson has pointed out, it is a panel data, so the number of observations in that panel is far, far greater than one would get doing a time series analysis using public data for that shorter period.

Q. But the problem with that is, you know, if you are dealing with the cost of a car, that probably does not go up. The wholesale price of that car might go up once during that time period for most cars. You would expect a company to announce price changes for its cars once, perhaps twice a year, would you not?

A. Well, two points I would make. So one is that obviously we have two results here. So we can see how the results change if one looks at a longer period and, you know, they are slightly different and higher. Secondly, it comes back to this problem that if one does not rely on this data, then what does one do, because this is the only data that is available for this sub-sector.

Q. The next, if we turn on to the other retail sector. So other retail. If we go to table 90 in your report at page 318 {RC-F/10/318}. I mean, other retail, as the name suggests, basically is a wrap-up, is it, not? So you have all of the main bits of retail like food and drink, and then this is a wrap-up for sort of all the other categories that are too small to warrant their own section, so it is just other, basically, but retail as opposed to services?

A. I agree, yes.

Q. If we look through the list of expenditure or the categories there, we can see direct sales, 20.8. If we work our way down. Jewellers we need to highlight because they are at 7.2%, but they are the ones you actually do some analysis for. Then if we go over the page, we see all the various other kinds of categories {RC-F/10/319}, working our way down. Pet shops is also highlighted at 1.6%, because again that is the other sub-sector you do some analysis for.

I think you also rely upon some analysis Mr Holt did in relation to cosmetic and beauty, which presumably applies to number 17, cosmetic stores, does it?

A. Yes.

Q. Okay. So you do the analysis for tobacco -- sorry, for jewellery, which is based on public data. You do analysis for pet shops, based on the company Pets at Home. Mr Holt's number for that one very small sector, which is what it was, 1.2%. Then you applied an average of the rate for jewellery and pet stores to the other 88% of the sector?

A. Yes.

Q. In terms of previous studies in this sector, the only

ones you found relate to pass-on rates in relation to tobacco products, and that is a very narrow category. If we go to table 90, we can see tobacconists come in at 23.0% in this sector, so obviously too small to even figure as a tenth of a per cent. So, I mean, those studies were of limited utility?
A. I agree, yes.
Q. Now, if we turn then to jewellery, which we have seen is 7.2% of the other retail sector, the analysis you have done here is to compare the CPI index for jewellery, clocks and watches with the PPI index for domestic produced, so UK produced, jewellery and bijouterie, which -- so once again, you are dealing with two slightly disconnected data series, are you not? The CPI index includes clocks and watches and your PPI index does not, and the PPI index includes bijouterie. Is bijouterie part of the basic CPI index or ...
A. Off the top of my head, I could not tell you.
Q. Okay, fine, but --
THE CHAIRMAN: Can you tell us what it is?
A. I think --
MR COOK: Objet d'art is the ... Knick-knacks, perhaps. Trinkets and knick-knacks. So these are -- probably the bigger one is clocks and watches which is on the CPI index but not on the PPI index, and the point before,

which is obviously you would expect the weighting of domestic production to be -- in the PPI index to be rather different in a world in which, as we know, a lot of products are imported, and there will be simply different levels of imports of products compared to UK production?

A. Yes. Well, just to be clear, an issue for this sector is that we do not have the relevant data on the share of costs for this sector, so we do not know.

Q. I mean, we do not know, but we can draw some sensible conclusions just knowing what we know about the level of imports into this country, that UK production and imports are likely to have very different ratios for different products, are they not?

A. Yes.

Q. So you said, given that you do not know about these things, it is not a very sensible or reliable basis for assessing pass-on at all, is it?

A. Well, I would say it -- so I looked at all of these -- well, not all of these different sectors, at least the largest of the subsectors in other retail and tried to identify whether there were any -- where it were possible to produce an estimate using public data, and this was the only one of the largest subsectors where I felt it was possible to do so.

Q. Are you saying it is the best of a bad job?
A. Well, I say it is the best evidence that was available in terms of public data for this sector.
Q. So you perform sort of similar familiar analysis. Then in relation to, again, converting it, as we see, at page 326 {RC-F/10/326}, this is another sector where you use the SUT data, and, again, it is another sector where the SUT data is one that you have dismissed as being unreliable, because here it is in relation to other manufactured goods which is a whole range of different products. So it is another sort of piece of information which is just simply not that reliable, is it?
A. Well, I think we discussed this in terms of other sectors. So it is the best information that is available.
Q. In relation to -- so extrapolation here. Again, you test by removing five years of data. Ms Webster looks at a shorter period. The numbers come down. Again, it is another example of that happening in practice. Unless there is something you wanted to add to your response, presumably we have been over it already?
A. I think we have been over this, yes.
Q. Okay, fine. So that is in relation to jewellery.
In relation to pet shops, you use Pets at Home data. That is in relation to 2016 to 2023. So quite a recent

period, significantly post-dating the Merricks claim period.

If we go to 4.627 {RC-F/10/328}, which again records the approach to operating expenditure and how you allocate it, so again it is the same one that you allocate by reference to direct costs?

A. Yes.

Q. This is also another sector where you use the actual VAT rate, not your -- because you use actual data from Pets at Home, do you not?

A. Yes -- well --

Q. Which is at paragraph 4.643(c), if you want to see that.

A. Just to be clear, somewhat surprisingly to me, not everything that Pets at Home sells has VAT charged on it. Some of the things that Pets at Home sells are zero-rated for VAT, so I used what is the effective VAT rate for Pets at Home from their own data.

Q. Presumably a certain amount of pet food is zero-rated as being food, is that ...

A. Yes, well, I would not be able to speak for myself, but my dog would. But, yes, do not ask me to explain the rationale, but that just simply is the fact, that some of the products are zero-rated.

PROFESSOR WATERSON: -- rabbits are zero-rated, are they?

MR COOK: Okay. So, I mean, there is nothing additional

I want to add in relation to that. It is all the same points we have been over in relation to other sectors.

What you get, though, is you end up with your number for jewellery, which is 108.7%, and your number for Pets at Home, which is 55.5%, and you then average them and apply that average to the rest of the other retail sector, which is sort of the other 90%, with the exception of the beauty shops we saw where you used Mr Holt's number.

So I want to look at your reasoning in relation to that, which is at 4.660 {RC-F/10/334}. You say:

"While I do not consider data on either the jewellery sub-sector or Pets at Home to be fully representative of the other retail sector alone, considering them together provides a stronger indication of pass-on rates for the full sector."

Then it talks about a report which analyses distinct types of retail clusters in Britain, which you break down broadly into out of town shopping and then high streets and urban shopping centres. You then make the point that jewellery is basically something that you are going to find a lot more of in in-town shopping centres, whereas Pets at Home are largely located in out of town retail parks.

If we go to 6.80 at page 339 {RC-F/10/339}, you say:

"Together they represent less than 10% of the other retail sector. However, the jewellers sub-sector and the merchant Pets at Home represent examples of the two main retail customers in the UK, out-of-town and high street. I therefore consider my analysis of the jewellers sub-sector and Pets at Home data should provide a strong indication of pass-on rates in the other retail sector as a whole."

Mr Coombs, there was an entire joint experts' process addressing what factors were potentially relevant to pass-on. Do you recall that?

A. Yes.

Q. You were involved in and engaged in that. Would I be right in recalling that at no time during that process did anyone, including yourself, suggest that type of retail location would have an effect on pass-on?

A. Well, I think it is relevant in terms of the business models of these businesses to think about, you know, what type of business they are and what type of businesses they represent, and so that is the approach I have taken here.

THE CHAIRMAN: I am not sure that was an answer to the question.

A. So the question is saying: is this a factor that was identified in the joint expert process? The answer is:

no, it was not. But I would still think it is a relevant factor to look at. I also think, you know, it is important to not overemphasise this analysis, because although I do this analysis and use it to calculate a weighted average pass-on rate, I do not actually use that weighted average pass-on rate. What I use is I just use a simple average between the two data points I have, because that actually produces a lower number than the number that I would produce if I had calculated that weighted average. I think I have lost you there, sir, but ...

So Mr Cook is talking about some analysis that I did where I said, well, let us suppose that Pets at Home is representative of out-of-town shops and that jewellers are representative of high street shops, and if you do that and you get some data on the shares of those two different shops, what is the weighted average that you get?

Then I did something which was just cruder, which was I said: what is the simple average? I have for this sector two data points and these are the only two data points I have, so what is the simple average? The simple average produces a lower number, and therefore I used that lower number. So I took the more conservative approach of simply using the lower of those two estimates.

MR COOK: If we look back at 4.680, this is not concerned with your weighted averages, this is your reasoning for suggesting that your analysis of jewellers and Pets at Home should provide a strong indication of pass-on rates to the other retail sectors. So this is saying they represent two categories, or have shops in the two main retail clusters in the UK, and what I am putting to you is nobody has ever suggested that that is a relevant or likely factor that is going to lead into pass-on rates?

A. Well, I think the two points is that I think it may be relevant, and, secondly, the approach I have used is one of simply -- ultimately the approach I have used is this: I have said for this sector -- well, in fact let us step back a bit.

So for this sector, effectively I have looked at three different approaches. So one is the approach that we are discussing of trying to say that these are proxies for two different types of outlet and calculating the weighted average on that basis. Another approach is just to say: for this sector I have two data points, what is the simple average of those two data points?

There is a third approach, which is set out -- I will not go to it, but there is a third approach

I used which is to say, well, this is the other retail sector, and, as Mr Cook pointed out earlier, this is a collection of basically everything that is left over. So we have clothing and food and drink and so on, and then we have this residual category of all other types of retail outlets. What I did was just say I have estimates for the more specific retail sectors. I have an estimate for clothing, an estimate for food and drink, an estimate for household. What happens if I take the average from those others? Because that is an alternative approach, is to say, well, actually, the evidence that we have from Pets at Home and jewellers maybe is not sufficiently representative of this sector. Let us just simply use the data that we have from other retail sectors and calculate an average. So I calculate that average. I find that produces a higher number again.

So I have three data -- three estimates. I have triangulation from these other retail sectors, I have the weighted average of jewellers and Pets at Home, and I have the simple average of jewellers and Pets at Home, and of those three numbers I take the lowest, the most conservative estimate. You might argue, well, you know, none of those numbers is a perfect estimate, but from my perspective, those were the alternatives in front of me, and of those alternatives I took the most conservative approach.

Q. What I am asking about, though, is your reasons for saying -- the reasons why you are saying that your analysis of the jewellers sub-sector and Pets at Home data should provide a strong indication of pass-on rates in the other retail sector as a whole? That is -- the explanation you have given here, it is -- I mean, there is just no reason at all why two completely different businesses should have similar pass-on rates simply because they are geographically proximate in an out-of-town retail park?

A. Well, I think it might be relevant and so I have considered it, but, you know, as I say, at the end of the day I think this point is somewhat moot, because the approach I have used is the one I have just discussed, which is to look at the three different ways I can use the evidence that is available, and then I took the most conservative of those three approaches.

Q. But certainly the two principal ways of looking at it are still simply trying to work out what you do with jewellery data and Pets at Home data?

A. Yes.

Q. I am suggesting to you that in circumstances where you are talking about incredibly disparate kinds of businesses -- record shops, florists, computer software, chemists, porn shops -- the idea that data from Pets at Home from 2016 is going to give you any indication of what pass-on rates would have been for those businesses, or from jewellery, would give you any idea what pass-on rates would have been for those businesses in the 1990s or early 2000s, that is not giving you any data at all, is it?

A. Well, I think the point that I have made previously -- sir, I am conscious that I am repeating myself -- but the question is, well, what is the alternative? So we have two data points from evidence from within the other retail sector. We then -- I then say, well, is there an alternative piece of evidence? The only other alternative that I could -- I thought was relevant here was the triangulation from other sectors, so I also looked at that alternative. On the basis of looking at the three averages that I could produce from those different alternatives, I used the lowest, the most conservative approach.

Now, the alternative -- so the alternative, if one says, well, actually evidence from jewellers and pet shops is not sufficient, we cannot use that, the alternative is to use the triangulation from the other sectors, and that would have produced a higher estimate.

Q. But you do not put forward any reasons at all for suggesting that pass-on rates for food and drink retailers are likely to be ones you can read across to porn shops?

A. Well, the point I am making is that these are the alternative pieces of evidence available, and I think, you know, Mr Cook, you are pointing out that there are -- you know, none of these pieces of evidence are perfect, and I would agree with you that none of them are perfect, but, you know, I have been instructed to try and estimate pass-on rates here. So, you know, I could just throw up my hands in despair and say, "Sorry, I cannot do this. There is no evidence available". But I do not think that is strictly true, there is some evidence available, and I have tried to produce the best estimate I could, given the evidence that is available.

Q. That is what goes through your approach, is it not, that whatever you get in terms of data and whatever you get in terms of material, at the end of it you produce a number, even if you know that that number is imperfect, flawed, in whatever way it is?

A. Yes. So I basically try to do my best with the data that is available and I produce the best estimate that I can.

Q. Do you at any point think to yourself that sometimes you should say, "I am sorry, there just is not enough data for me to put forward any form of sensible number"?
A. Well, I think -- well, I suppose the two points are, one, is that I do not think that is the case. I think there is evidence that can be used here to estimate pass-on for these various sectors. So I do not think it is the case to say there is no evidence and it is not possible to estimate pass-on for these sectors. It is possible to estimate pass-on for these sectors. So, you know, that is what I have done. Given that it is possible to do so, I think the thing that is helpful to the Tribunal is to say, well, this is my best estimate, this is how I have approached calculating it.
THE CHAIRMAN: You went through the process, did you, of considering whether the evidence that you had was sufficient to put before the court as reliable evidence?
A. Yes. I mean, my view is that it is reliable in the sense that it is -- well, it is reliable in the sense that it is the best evidence that is available for me to put in front of the Tribunal. I do not agree with the implication that somehow because there are, you know, challenges and imperfections, it means that the estimates I am producing are in some sense sort of just random numbers or cannot be relied on at all. I am

saying that this is the best evidence that is available. I mean, I make the point that there are limitations with the data, in particular I think there are more limitations with the merchant data than with the public data, although other people will probably disagree with me on that, but that is my view. So I have sort of discussed what I thought were the limitations with the data that is available, but ultimately I would not agree that this exercise is completely worthless. I think that the estimates I have produced are informative about pass-on. Part of the reason for that is because, you know, I start with my report by discussing economic theory and expectations about pass-on. I also look at previous studies for sectors. Obviously for some sectors those previous studies are more useful than others.

So, you know, I compare my estimates with estimates from previous studies. I consider how -- you know, whether they are plausible, given economic theory, and my view is they are plausible based on economic theory, and, you know, in many cases they do seem to be consistent with previous studies.

PROFESSOR WATERSON: Can I just ask this: the previous studies you are looking at of course have been published in the large majority of cases and have therefore been through an academic refereeing process. Do you think that your analyses, given the issues, which are not your fault, would pass a similar test?

A. I think they would, yes, because I think -- I mean, the approaches that I have used are very similar to approaches that have been used in much of the literature. I think I might -- I mean, I am thinking -- I have not thought about this question before, so I am thinking on my feet here. I think I would be more cautious about the evidence that is drawn from the merchant data than the evidence that is drawn from the public data. So I think in terms of evidence from the public data, I would say, yes. In terms of evidence from the merchant data, I might be a bit less certain.

PROFESSOR WATERSON: Would you be -- do you think you would receive challenge in relation to, for example, the cases where you have experimented with various dummy variables for various months and without an economic reason behind that?

A. Well, my limited experience of submitting journals for publication is that there are always lot of challenges made about these sort of things, so no doubt there would be, yes.

PROFESSOR WATERSON: Thank you. I would agree with that, by the way. I also faced challenges.

MR COOK: Given all these uncertainties, you have nonetheless come up in this sector, for example, at the end of the day, with a figure of 88.8% pass-on. I mean, given the imperfections we have been talking about, I mean, that level of precision is just simply a fantasy, is it not?

A. Well, it is -- so I am being transparent in terms of I am saying this is the number that I have estimated, and, you know, I provide it to one decimal point. Now, my expectation is that no doubt the Tribunal will end up wielding a broad axe and will end up with something which is much more of a round number than the numbers that I am producing, but I am sort of leaving that wielding of the broad axe to the Tribunal to do. I am just saying these are the numbers I calculate, so I am not sort of trying to round up numbers in order to obscure what the estimate is.

Q. You are not anywhere giving a range of uncertainty to any of the figures you produce, are you, even when you know that a lot of the inputs have problems with them and, to some extent, you know, some idea of how sort of wide-ranging those imperfections are. You do not at the end of it give any idea of, you know, you think it must be in a range between -- for this is one you say 88.8%. Does that mean you are confident it is above 70%?

A. So -- well, I suppose there are two points here. One is that, you know, obviously I have set out here there are a range of different approaches that can be used to calculate a pass-on rate for this particular sector, and I have set out those approaches and the different answers you get, and said I have chosen this one, which is, you know, the bottom of the range of three data points that I have. So that is the evidence I am putting in front of the Tribunal.

Now, the second point is I think what you are suggesting, Mr Cook, is that I should provide something like a confidence interval around the data points. Now, the issue with the public data is that that does not really work because of the model I am using. If you were to quote confidence intervals for results from the type of model I am using, they are just not reliable, so that would be -- well ...

Q. I was not necessarily suggesting formal confidence intervals, because I am alive to the point you make in relation to your modelling. But you are not giving any idea to the Tribunal of the range of uncertainty you think exists compared to the actual very specific numbers you are putting forward?

A. Well, as I say, the problem is that I cannot really quantify that, because that is the nature of the model that I am using, is you cannot -- the way to do that is to produce a confidence interval, and confidence intervals are not accurate, given the type of model that I am using.

Q. So in terms of your expert confidence, when you say here that you have a number of 88.8%, how confident are you that pass-on is above 80% in that sector -- in the other retail sector?

A. Well, I cannot answer that question. All I can say is that this is my best estimate.

Q. You do not have any professional view on how likely it is to be above 80% or 60% or -- which of course is higher than your Pets at Home number?

A. Well, that would be guess-work, so I do not -- I am not going to sort of guess.

Q. Okay. So you do not have any evaluation of how likely these numbers are to be -- even in the right ballpark be right?

A. Well, as I say, the way of doing that would be to calculate a confidence interval, but a confidence interval would not be reliable, given the model I am using.

Q. The next sector we move on to then is clothing. In relation to clothing, you deal with this -- you cannot identify any public data. That is just a fact, not a criticism. So what you do is you analyse Primark data, and you analyse it for the period 2015 to 2019, so a five-year period. Then you read that across the entire clothing sector and extrapolate it back to the Merricks claim period. That is a summary of what you do in this sector, is it not?

A. Yes.

Q. If we go to paragraph 3.231, page 126 {RC-F/10/126}, you describe yourself in relation to clothing as having -- you say:

"The table shows I have data that offers near complete sectoral coverage for five sectors."

Clothing is one of the ones you describe as having near complete sectoral coverage. The reality is you have data from one merchant which covers a five-year period, starting 23 years after the beginning of the Merricks claim period. It is --

A. Yes, well, I would agree with you that that is an inherent limitation of all of the merchant data, is that it is data from one merchant which then has to be extrapolated across the whole sector. I think the point is that the merchant that I have here, Primark, sells products which represent the whole sector. So rather than other cases where, you know -- so the case we have just been describing, so other retail, I have data from

Pets at Home, but Pets at Home does not cover the whole other retail sector. So that is why for that row, you know, the coverage is partial, whereas for clothing, Primark sells a range of products which effectively represent the whole sector.

But I agree with you that it is only one merchant and therefore that is less representative than if I had public data for the whole clothing sector.

Q. Now, in relation to Primark, again, you try to do the total cost analysis that you say is the right proxy. You have the same operating costs approach that we have already discussed. Is that right?

A. Yes.

Q. Then in relation to your calculation of pass-on rates, if we go to paragraph 4.457 in this report, page 281 {RC-F/10/281}. Now, I appreciate what you have done in your fourteenth report -- your second report -- is you have changed your calculation of elasticities to a limited extent. You have updated your modelling?

A. Yes.

Q. So I appreciate that these are not the final numbers you use in due course, but the other stages of retailer mark-up and effective VAT rate, that reflects the same approach that you take, and the same numbers apply, does it not?

A. Yes.

Q. Okay. All you do in your fourteenth report is simply say, "I apply the same approach I set out, including in this paragraph, to get to the final numbers", which is why we are looking at this bit.

In relation to the retailer mark-up, and just obviously to identify that the specific number there is confidential, so we are not going to mention the number, but we can obviously read it and get an idea of what we are talking about in relation to that. It is a startlingly high number, is it not, Mr Coombs, compared to all of the other retailer mark-ups that you have used in the context of your analysis?

A. Well, it is calculated on the same basis as the mark-up that I use for other merchants.

Q. Well, it is startlingly higher than the net margin that you calculated for Primark in the early section of your report. If we can go to page 37 at paragraph 2.36 {RC-F/10/37}. You see at the bottom of the page, you refer to Primark's average net margin. This is public data, so we can say it: Primark's average net margin between 2005 and 2020 was 6%, compared to the confidential number that we have just seen.

In relation to other sectors, you have identified single digit mark-ups. Fuel was 1%. Furniture 3.2%.

4.1% for food and drink. Some other ones which were 10.7%, travel agents. 14.6%, restaurants. Various ones -- a range of vehicle services ... public data. The highest other one is 21% for hotels.

So the number here is just completely out of keeping with anything you have done in any other part of the economy for a sector of the economy which you are saying is incredibly competitive. Well, I mean, it is fair, is it not?

A. Yes, well, I suppose you are saying that this is the highest number out of those different sectors?

Q. Well, it is not just the highest, I mean, it is dramatically larger than all of the others and quite a significant margin higher than hotels, which is the absolute highest of anything else?

A. Yes, but this --

Q. It is not in the same range, it is significantly higher, is it not?

A. Well, it is the number that I derive from the data that is provided by Primark.

Q. If we look at paragraph -- page 281, paragraph 4.462 {RC-F/10/282}. If we start on the previous page. You again produce some analysis here in the context of sectoral extrapolation. You say:

"... the non-luxury clothing segment, in which

Primark operates, is by far the largest segment of clothing, representing 94% of the value of UK clothing sales [public data], compared to 6% for luxury ... Within non-luxury clothing, Primark is often seen as a value or low-cost retailer ... a recent McKinsey report found that between 2010 to 2018 average margins at a global level were broadly similar across 'value and discount' retailers (... 9%), 'mid-market' (10%), and 'premium ...' (10.2%)."

You say:

"Furthermore, UK clothing retailers operating across these segments highlight the significant competition inherent in the sector."

So there are all sorts of data points here which are suggesting the kind of margin that you have used and calculated in your numbers is just completely out of keeping with any other information?

A. The problem is that we are comparing different data sources which are calculated on a different basis, so I think there are different ways of calculating margins. So I do not think one can sort of necessarily compare these numbers with each other.

Q. Well, the end effect of the number that we see is, because essentially you multiply your elasticity by that percentage, it has quite significant effect upon -- I

mean, every single time you do this, the margin is
always the multiplier which makes the elasticity into
a slightly higher percentage, and here it makes it --
I am obviously not saying the number -- a significantly
higher percentage. So it has a real impact, and I am
saying it is completely out of keeping with any other
piece of analysis that one sees you have done, any other
set of numbers one sees for fashion, for Primark, in
public data. I am suggesting it either cannot be right
or, if it is right, then Primark is frankly not
representative of the general run of clothing retailers.
A. Well, as I say, so this -- I have calculated this
number on the same basis that I have calculated the same
number for other merchants. So it is calculated on the
same basis. I am not quite sure if you have a sort of
methodological point, or you are just saying you are
looking at the number and you think it is a bit high,
which seems to be what you are saying.
Q. I am saying this is a number that you multiply up by the
significant percentage we see there, that is completely
different from any other piece of analysis that you do,
and the other analysis that has been put forward are
Primark's margins. It does not make any commercial
sense, that number.
A. Well, I suppose -- but then the question is: well, you

know, what is -- if you think that there is an error in this calculation, then what is the error that you think has been made in this calculation, because it is the same approach that I have used for other merchants, so ...

You know, it is one thing to say this number is higher than for other merchants, but it is another thing to say, you know, it is wrong. If you are saying it is wrong, then there has to be a reason why it is wrong.

MR TIDSWELL: Do you think there is anything surprising about it, Mr Coombs, about the size of the number?

A. Well, no, I had not previously thought that there was anything surprising about it. I just thought that these margins would vary across different businesses.

MR TIDSWELL: Looking at it now, do you think it is a surprisingly large number, given the other numbers we have looked at?

A. Well --

MR TIDSWELL: In other words, looking at it now, do you think there is something that makes you wonder whether there might be a problem with it?

A. Yes, I suppose possibly, yes, given that it is higher than other numbers, then, you know, I might want to, you know, think about whether there is a reason for that. But at the moment it is not obvious to me that there is any reason to think that there is a problem with this number.

MR COOK: If we go back to where you see it, if you go back to page 281 {RC-F/10/281}, and if we look at footnote 855, you do provide an explanation there that says that -- it does not appear to be confidential -- where you say you normally:

"... exclude depreciation from the computation of total costs consistently across merchants. However, given that Primark reports depreciation is part of its operating costs, [you say] I include depreciation in the computation of Primark's markup to avoid overestimating the true markup for this merchant ..."

So it does seem here that you have done something different in relation to depreciation than you have done with all of the other merchants, but, on the face of it, it then produces a number which is completely out of a keeping with all of the others, and completely out of keeping with public data of Primark's normal profit margins. That is why I suggest to you that is potentially -- and I must say I have worked through it and could not understand, because of that explanation at that level, what the issue was. But on the face of it, it just simply clearly cannot be right considering everything else we have seen.

A. Well, the point that is being made here is that depreciation is being included as part of the operating costs here. So therefore, when I calculate the mark-up, I calculate the mark-up on the basis that depreciation has been included as part of operating costs.

THE CHAIRMAN: So that would reduce the margin, would it not?

A. Yes. Precisely, yes.

THE CHAIRMAN: So the actual figure might have been higher?

A. Yes. So that is not something that would lead to an overestimate of the margin, no.

MR COOK: That was the one bit I could see that it seemed to be different from what you had done everywhere else, but I will leave it at the level of the point I have already put to you.

This is another merchant where you have used actual VAT information, rather than your economy-wide rate, have you not?

A. Yes.

Q. You say, at paragraph 4.473 on page 284 {RC-F/10/284}, this is another sector where you say, having considered competitive conditions, that your mark-up may underestimate pass-on rate -- sorry, may overstate pass-on in the very early part of the Merricks claim period. That is the point you make at 4.473.

But then you say, at 4.474:

"My analysis of Primark's data is likely to underestimate the pass-on rate due to firm-specific costs."

The point we have already dealt with.

But you have -- at this point you have obviously increased your number since you wrote this report. Your pass-on number for this sector is now 102.9%. I mean, there is no basis to think that that is an understatement, is there, due to firm-specific costs?

A. Well, the point I am just making is that there are two effects, and I do not know what the magnitude of these two effects are, so therefore I cannot actually make an adjustment for either of them.

Q. I am putting it to you that, given you come to a pass-on rate which is over 100%, that you have no reason to think that that is an underestimate at all, do you, based on firm-specific costs?

A. Well, I simply do not know. I suppose what I would say is that you would not expect there to be a very material difference, given that this pass-on rate is already very high, so I would agree with that. But the point I am just making is I cannot actually quantify what these effects are.

Q. If we turn now to financial services. You do two bits of analysis here. First, you calculate a pass-on rate for Allianz using data on car and home insurance. That is data for an eight-year period. Then you apply that to the entire insurance sector for the Merricks claim period. Then you also do a pass-on rate for WorldRemit. That is data using 2022 to 2023, not quite two years of full data; it is 22 months or 23 months. Then you apply that to the rest of the financial services sector, which is not insurance, and you read that back to the Merricks claim period. Is that a summary of what you have done with this sector?

A. Yes.

Q. So, in relation to Allianz, I mean, the big problem with the analysis of pass-on for insurance companies is that the key cost ensured by insurance companies is claims costs and, you know, the difference is that fundamentally when most retailers sell a product, they already know what it has cost them and they are simply adding on -- they have the potential to add on a margin to try and know that they are getting more than they paid for it. Insurance is different. What you are doing is agreeing to accept a risk, which you can try and model in no doubt very sophisticated ways but is obviously uncertain, so the actual claims costs are going to be, you know, realistically different from

those you expect. So that is the big difference we see with insurance, is it not?
A. Yes.
Q. That is one of the big problems that all of the experts found in trying to model a pass-on rate for Allianz, exactly that issue, which is actual claims costs are, you know, unknown at the time when the product is sold?
A. Yes.
Q. What there is no information about is what the expected costs were that Allianz would have known or used in its pricing. We do not have that information, do we?
A. No.
Q. Okay. So if we can go to your second report at paragraph 4.580b, which is page 329 of the fourteenth report {RC-G/9/329}. It is paragraph b there where you talk about what Mr Holt has done, but Mr Holt has constructed a measure of expected costs -- claims costs to reflect Allianz's approach to price setting. Making some of the points I have made, Allianz does not provide data and did not provide data on expected claims costs, instead on claims costs actually incurred, and Mr Holt has proposed an approach which calculates expected claims per policy as follows: he calculates the number of active policies; he calculates monthly claims costs per active policies as a ratio of claims costs on the

number of active policies. Then (iii) what he does is he tries to work out total expected claims costs by the current month's claims cost, the previous five months and the future six months, which but sounds very complicated but in practical terms is almost the last six months -- you know, at the moment the policy is sold effectively you are saying six months' data before and after, give or take?

A. Yes.

Q. That is -- then you go on to say, unlike Mr Holt, you have done something different, but you have reconsidered your analysis and agree with Mr Holt's approach.

I mean, in relation to that, I mean, what it still means is half the data that you are considering is based on what happens in the future, which is unknown and predicted but almost certainly predicted wrongly when the policy is sold. That is right, is it not?

A. Yes.

Q. With the sort of -- keeping it simplistic -- the prior six months of data, that you do know what those prior claims were for different policies, but, given the general inflation in life, you know that if the same events happen they might well cost you more money in the future. You are very unlikely to get similar claims costs in the future as the ones you had in the past just on the basis that things are more expensive over time, repairing cars for example?

A. Well, if you have some knowledge of what the relevant inflation rate is going to be, then you might factor that in, yes.

Q. But you have not factored that in?

A. No.

Q. So what you have done is looked then at, in effect, six months' historic costs, the actual six months costs going forward, but the ones that are not known at the time, but you do not take any account of for a 12-month policy the cost of the six months of claims in the second half of the policy, so you do not take account of that at all?

A. Sorry, could you repeat question?

Q. So what you have done is you have taken six previous months, which are known but not relevant to this policy, six future months based on what happens in the future, which of course was not known when the policy was sold, and you have done nothing in relation to months 7 to 12 of a 12-month policy?

A. By months 7 to 12, you mean --

Q. In the future. When you are selling the policy, you are selling 12 months of risk, assuming it is a 12-month policy which is often standard, and you have not given any thought to what months 7 to 12 of those claims will be because you are looking at a measure which is half historic and then half about the next six months?

A. So, yes, I mean, I think it is the way you described it a moment ago, it is the 12 months centred around the date on which the policy is written that the cost data refers to.

Q. So if half the costs are not relevant to this policy, half are unknown at the time and you are not looking at the second half, I mean, that is an incredibly imperfect measure of any form of cost at all, is it not?

A. Well, I mean, the reason I adopted this approach is that, as you say, I took a different approach in Coombs 13. When I then saw what the other experts had done, so Mr Holt had used the approach described here, Mr Murgatroyd, who was the expert for Allianz at the time, also used a very similar approach, I mean an almost identical approach in the sense that he also looked at the future six months and the past six months of claims costs in order to calculate his measure of cost for a particular proxy -- a particular policy.

So I adopted an approach that was used both by Mr Holt and by Mr Murgatroyd, who was the expert for Allianz.

Q. But I was asking you about whether it was the right

approach. You might be in company. Is it good company?
A. Well, I think it is. I think it seems -- well, it seemed to me more sensible than the approach that I had previously been using, in that it took account of the fact that when somebody is selling an insurance policy they probably are not just thinking about their past costs, they are probably also thinking about their expectations for the future, and obviously they will have imperfect knowledge about the future, but the best proxy that we have for the future is the data on future costs over to the next -- over some period.
Now, one can use a judgment in terms of saying, well, should you -- an alternative approach would be to say, well, let us use the future 12 months and ignore the past completely, or an alternative is to do what I did in my first report which is to ignore the future and just use the past and this is, if you like, a pragmatic compromise between the two of saying let us use six months of the future and six months of the past.
Q. In terms of the other aspects of your analysis, so, again, this is an overheads similar approach to the ones we have talked about, is that fair?
A. Yes.
Q. In relation to VAT, if you go to page 299 {RC-G/9/299} --

THE CHAIRMAN: In the first report, is it?

MR COOK: Sorry, in the first report, yes {RC-F/10/299}, and it is 4.515. So you note there the insurance market is exempt from VAT but subject to Insurance Premium Tax instead. So what you have done is you make an adjustment in relation to IPT rather than VAT so, again, this is another sector where you have used the actual data rather than the economy-wide VAT rate?

A. Yes.

Q. Where you get to at the end of this is pass-on rates that you calculate for motor and home insurance only. You do not have -- and they are materially different, I now can't remember if they are confidential or not, but you get materially different results for the two sectors, do you not?

A. Yes.

Q. You do not have any basis to know which either of those are applicable to other main categories of insurance, life insurance, matters like that, do you?

A. No.

Q. This is all data for 2014 to 2022. I think you identify there are reasons to think that certain categories of insurance would have been less competitive so with higher -- sorry, lower -- would have been less competitive historically which leads to potentially lower pass-on rates?

A. Yes.

Q. So that is Allianz.

In relation to WorldRemit, again, you have done total cost pass-on analysis of the overheads approach that we have discussed already. Now, in terms of the relevance to the number that you get, WorldRemit is in the digital remittance sector and that represents less than 1% of credit card expenditure?

A. Yes.

Q. The data, it is a very short and recent time period, February 2022 to December 2023, and what you do then is you read it across to what you describe as other intermediate transactions. So if we go to page 307 {RC-F/10/307}, paragraph 4.550, you say -- we can start in the previous paragraph, you say:

"Although [digital remittance] represents a small share of credit card expenditure, retailers in this sub-sector intermediate transactions between parties ... and generate revenue by charging fees or commissions for doing [so]."

You say it is a similar business model to other firms in other subsectors.

If we go to the footnote, 942, at the bottom of the page, we can see cash disbursements (automatic and

manual), so that is going to be ATMs, would that be right?
A. Yes.
Q. Financial instruments, merchandise and services. That is going to be, what, some kind of breakdown insurance or what is it? Then non-financial instruments, foreign currency, travellers cheques and security brokers and dealers. None of those are going to be likely to have anything similar in terms of a financial model to a digital remittance company operating in a sector where there are a whole bunch of other well-known digital remittance companies available. There is just no reason to think there is any basis to read across the numbers, is there?
A. Well, all I am saying is that they are similar in the sense that they are sort of financial intermediary businesses, but I am not saying that they are identical to the business of WorldRemit.
Q. If we go to page 308 {RC-F/10/308}, what you say in relation to WorldRemit is paragraph 4.556. You note that WorldRemit was founded in 2010. It is active in what is a relatively young market, the digital remittance market, and, as a result, you do not assess that the pass-on rate estimated using WorldRemit is applicable to the Merricks claim period. So do I read

that correctly to say you just have made no attempt to check whether it is accurate or not?

A. Yes.

Q. So is this the one place where you say there is not enough data, "I cannot do it"?

A. In terms of the -- in terms of understanding extrapolation backwards, yes. Well, I think it is in the nature of the business that it is difficult to extrapolate backwards.

Q. You say you do not assess whether it is applicable, but then you simply apply the WorldRemit number to the Merricks claim period, do you not?

A. Yes.

Q. So a number that you have acknowledged you have not made any attempt to check is accurate?

A. Well, because in this case it is not possible to do so.

Q. If we go to 4.559, on page 309 {RC-F/10/309}, you say, the final sentence:

"I consider that using the Pass-on Rate I estimate for World Remit for these sub-sectors is conservative given than the Pass-on Rates from previous studies are higher, at close to 100%."

We can look out the previous studies at Table 82 at page 287 {RC-F/10/287}. It is a fair summary, is it not, that all of these studies that you refer to are all concerned with the pass-on of money market rates, often potential bank rates, to bank interest rates or bank lending rates?

A. Yes.

Q. Which is just a completely different kind of business model, not least because a lot of financial products are directly linked to the Bank of England rate?

A. Yes. So I make this point at 4.484c, that I say the studies are most informative of pass-on rates in the banking sub-sectors of the financial services sector is what I say about these studies.

Q. But, as I have just shown you, you say you using the WorldRemit numbers is conservative because the studies have shown much higher rate, but the studies are dealing something completely different, which is bank lending and how far that is influenced by money market rates. So it is not conservative to say, "I have not applied a number which is completely irrelevant to the businesses I am talking about"?

A. Well, I am not -- so nowhere do I apply the number from previous studies in order to calculate a pass-on rate. I just simply note whether, you know, what happens when you make the comparison and I just note that when you make the comparison, the numbers I have used are much lower.

I think it also is relevant if we might go to the table. I do not know if everybody still has the table that Mr Cook -- nobody seems to have used it so maybe we could make one last attempt to do so. So if we actually go to page 3 at the bottom, and the reason I am just going there is just to show the numbers that I actually do use because, based on what Mr Cook said earlier, I changed my approach to Allianz.

So these are the numbers in my second report, as Mr Cook refers to it, Coombs 14. So the numbers for insurance are for motor is 61.5%, for home is 39.1% and then for money transfer is 36.9%.

So the point I would just make is that although, you know, there might be questions about the relevance of WorldRemit, you know, again we come back to this question of, well, what are the alternative sources of information that one can use to estimate pass-on for this sector? So the only other -- if we take Mr Cook's point and say, well, the previous studies are not necessarily going to be relevant, then the only other data point is the estimate for the insurance sector. So one could extrapolate from the insurance sector across or one can extrapolate from WorldRemit across and, of those two options, extrapolating from WorldRemit actually is the lower number so is the more conservative approach.

Q. You have no reason to think the insurance numbers are applicable to ATMs and the various other categories we saw earlier, do you?

A. I am just saying of the two options available to us, the approach that I have used is the more conservative approach.

MR COOK: Sir, I have about another 20 minutes, just to finish off the last two sectors, and --

THE CHAIRMAN: You got our hopes up last night.

MR COOK: I did.

THE CHAIRMAN: But we will have to return to that at 2 o'clock.

MR COOK: Thank you, sir.

THE CHAIRMAN: Alright.

(1.03 pm)

(The luncheon adjournment)

(2.00 pm)

MR COOK: Good afternoon, Mr Coombs. You will be pleased to know we are down to the last two sectors. The penultimate one is mixed business, that is department stores, catalogue stores, discount stores, matters like that. That sector is where you have not identified any relevant public studies; correct?

A. Yes.

Q. There is no public data you have identified you can use no merchant data you can use. So what you do is you create an average from food and drink; household, which in itself is just your furniture number is 21% of that household market; correct?
A. Yes.
Q. Clothing, which is based on Primark data for 2015 to 2019, we have seen; other retail, which is based essentially on the average of jewellery and Pets at Home data, which is (inaudible) jewellery at 7% and Pets at Home at 1.6%, and then the rest is -- uses the average of those two.
A. Also Mr Holt's estimate.
Q. Mr Holt's very, very small one on this. So you average those four and then you just simply apply that average to the mixed business sector?
A. Yes.
Q. I mean, the reality is you cannot have any confidence that that is anything like a number that actually reflects the pass-on rate for those different businesses?
A. Well, I suppose the -- well: two points. Firstly, the point I have already made about the fact that there is not any evidence that relates specifically to this sector, and therefore the only sort of approach that

seemed to be available was to extrapolate from other sectors.

I suppose the other thing that influenced my thinking was thinking back to the hearing in this case in January, where the Tribunal was suggesting that in moving this case forward and ensuring that the trial could take place in November and December this year, we needed to sort of get on with it and we needed to make the best use of the evidence that was going to be available, and there might be circumstances where evidence was not available for a particular sector, and if that was the case, it would be necessary to triangulate from other sectors.

So, in essence, that was the approach I was taking, that there was no evidence that was available specifically for this sector, and therefore the only option was to triangulate from other sectors.

Q. But looking at your triangulation, you cannot have any confidence that that actually reflects the pass-on rate for those businesses really?

A. Well, okay, I am trying to interpret your -- I can interpret your question in two ways. One is whether you are saying is it a reliable pass-on estimate for each of those other sectors, and I would say, yes, I have a reliable estimate for each of those other sectors.

Then you are saying is it a reliable estimate for this sector, and I am saying, well, it is the best information that I have available for this sector.

Q. In which case we will move on to the last sector, which is other services, and this incorporates things like utilities, so that is gas, electricity, water, telecoms, contractors, so building contractors of various kinds, gardening, vets, legal services, anything that is not sort of entertainment, you know, vehicle services, anything that is left over after we have dealt with all of the larger sectors that we have looked at.

What you have done in relation to this sector is you have done some pass-on analysis for Three, the mobile phone company, produced -- based on their data for 2017 to 2022 and produced numbers on that which you read across to the telecoms sector. That is the only sort of substantive analysis that you did originally. You have then picked on -- picked up on Ms Webster did some analysis on utilities, Mr Holt did some analysis on, I think, five subsectors that you have used in this context ...

A. Four. I think he did -- there are his four sectors, plus Ms Webster's sector makes five in total.

Q. Okay, fine. In which case, I thought it was five but we will not split hairs. I will not go through all of them, you will be pleased to know.

Absent those ones where you had something specific, the majority of the sector, you then do an average where you average entertainment, which is in practice restaurants, financial services which we have seen, hotels, travel and vehicle services. You produce an average of that and then you average it with Three. Is that right? You pick a mid-point between Three and that?

A. Yes.

Q. In relation to your analysis of Three, this will be -- so this, again, has a similar approach to overheads that we have already dealt with. Is that right?

A. Yes.

Q. Again, you use actual VAT --

A. Sorry, maybe I should just, for completeness, say that in the case of Three, what I also did was I used a moving average of the overheads. So rather than just the contemporaneous overheads, it is the moving average over three, six or 12 months.

Q. In which case, what do you say that adds to the analysis?

A. Well, it reflects the fact that overheads might not be influencing prices immediately. They might be influencing prices with some lag.

Q. I thought your analysis was always meant to identify lagged effects in terms of -- is this just simply because of the different model you use here?
A. Yes.
Q. Okay, fine. I think I asked -- you said you used actual VAT in this context, again, not your VAT average?
A. Yes.
Q. Is that right? So, fine, in terms of Three and where you get to with that, what you do is you -- if we go to paragraph 4.733, which I am afraid I am missing a reference for. {RC-F/10/354}

So in relation to Three, so you have your Three pass-on numbers, and then you say:

"As a mobile phone provider, Three is active in the telecoms sub-sector."

You essentially conclude that you can extrapolate from Three to the telecoms sector as a whole. You go through, at paragraph 734, some of the history of Three.

If we go over the page {RC-F/10/355}, then you say:

"Given Three's presence in the UK mobile phone services market, I would expect it to represent a good level of the pass-on rate that would should observe across mobile phone service providers in the UK."

Then you essentially just jump from there to applying it to telecoms.

Did you give any thought to the position in relation to the fixed line market?

A. In the sense that there might be a difference between the fixed line market and --

Q. British Telecom and other businesses which provide a fixed line service to customers. BT in particular has regulation in terms of -- it is price regulated in relation to how it can price. So how can you infer that a pass-on rate, even if it is applicable, for the mobile phone market applies to BT in the context of a regulated setting of price?

A. So -- well, no, I did not explicitly consider that.

Q. In terms of the historical bit of this, so thinking about whether Three is likely to be a good indication of what pass-on rates would have been like going back to the Merricks claim period.

Now, you do address this in particular at paragraph 4.738, which is 356 {RC-F/10/356}. You talk about the technological innovation, growth and increased competition, and the various bits that take place.

Then you go -- you conclude at 4.740:

"Therefore, while the technological landscape was significantly more advanced during 2017-2022 the overall industry dynamics and structure are comparable between the Merricks claim period and the 2017-2022 period."

One of the things that you do not give any consideration to is the massive change in the proportion of people that held mobile phones. I mean, the number of people that held mobile phones in 1992 would have been a very small percentage of the population as opposed to their ubiquitous presence in at least the adult population in the UK. That is a very substantial change in what has taken place and, in particular, the efforts the mobile phone companies were making to grow their footprint to all of those people, and that is likely to have had an impact on how far they saw an advantage to encouraging people to take up mobile phone services for the first time?

A. So, no, I suppose -- well, so the answer to your question is, no, I have not specifically taken account of that. I suppose the question is what impact that would have had. The thing that I sort of focus on here is in terms of the structure of the market and the level of competition and the fact that that, although there have been lots of developments in the market, that sort of structure of the market has not changed over time.

Q. When you are sort of -- you have a market where people are actively trying to grow their presence in it, that is likely to have an impact, potentially, because there is a motivation to try and keep prices low for long-term future gains. It is sort of the Amazon model of make losses now in order to make profits later. That is potentially something that could impact upon pass-on rates, is it not?

A. Well, that is sort of getting into the realms of speculation as to whether that would have had an influence on the way that mobile phone companies were pricing, particularly given that they still would have been in competition with each other, even in the earlier years.

Q. It was speculation on the basis that you did not look into it or consider its impact?

A. Yes, I am just saying that that -- yes, that would be speculation, yes.

Q. In terms then of reading these numbers across. So what you do is you have your Three number for telecoms, and then you produce an average of the five or so service sectors I have mentioned, and then you average, you know, average Three plus your average from those other sectors. I mean, the end result of that is basically to make Three much more important in that average, is it not? Three ends up basically being 50% of the weighting of that final average, whereas all those other sectors are then small bits of the rest of 50%?

A. Maybe we can go to where I actually set out these

numbers in my second report in Coombs 14.
Q. Yes. (Pause)
A. So this is -- so this starts on page 412 {RC-G/9/412} where -- so this shows the pass-on rate that I have calculated for the other service sectors.
Q. Yes.
A. So there are two different ways of doing this, so it is either calculating a weighted average or calculating a simple average, and they produce numbers which are not actually that much different from each other, but I use the lower of the two numbers here, the 76.6, rather than the higher numbers that you get from the weighted average.
Then if we go to page 414 {RC-G/9/414}. So this shows what I am doing in my second report. So we have the telecoms sector, which has an estimate from Three. We then have the five subsectors, where I have adopted the estimates from Ms Webster and Mr Holt. Then we have the remaining 26 subsectors, where I take the number that I triangulated from the other service sectors, the 76.6.
Q. So Three does not in fact feed into that --
A. Sorry?
Q. Three does not in fact feed into the average for those 26 other subsectors?

A. No.
Q. In which case, I apologise. That was put on the wrong premise then.
If we look though at what -- fine, so you do it in that way.
In relation to what you do with Mr -- sorry, I am going back to my notes. In relation to what you do with the other 26 subsectors and the average you do there, I mean, that really is the same issue with mixed business, that you are using a lot of other estimates from other sectors with very different kinds of business, and, you know, all you are doing is saying this is some data I have. You know, is it -- this is the best you have, is that your answer in relation to that?
A. Maybe I will make two points. So the first point is the point I made earlier, that, you know, this is, I think, consistent with what the Tribunal was discussing in January of, where there is a lack of data, triangulating from other sectors.
The second point I make is if you look at -- again, think about the options here that we have. So when we were -- so in other retail, I had a similar choice, that I could either use a triangulation from other sectors, or I could use the average of the data points I had from

within the sector, and in that case I found that using the average of the data points from within the sector produced a lower number, so I took that more conservative approach.

Now, here, we have the opposite situation, which is that if you take the data points that I have from estimates that actually relate to this sector, so my estimate from Three and the estimates from Ms Webster and Mr Holt. From Ms Webster and Mr Holt, you will see that they are higher than the number I get if I triangulate from other sectors. So in this case, the conservative approach is to do the opposite, is to use this triangulation, rather than just use the data points from within the sector.

So I used the data points from within the sector for the sub-sectors that they relate to, and then for the remaining 26 sub-sectors I take the more conservative approach of using a triangulation from other service sectors.

I am not sure if that was clear?

Q. In relation to Mr Holt's numbers that you use, I am not going to try and go through all of them, but just to understand, so hopefully you can answer at the level of, you know, the ones you are looking at generally. All of them are based on the analysis of either just a labour

measure or some element of COGS with a labour measure.
Is that correct?
A. Yes.
Q. So none of them are close to the total costs pass-on analysis that you say is the right way to look at MSCs?
A. Yes.
Q. In relation to labour, all of -- in relation to the labour element, whether it is the entire bit or a part of it, all of them use some version of the Average Weekly Earnings index?
A. Yes.
Q. All of them use Average Weekly Earnings data in relation to a much wider sector than the one under consideration, do they not?
A. Well, yes, I think we discussed that point.
Q. Now, before deciding whether to adopt Mr Holt's numbers, did you consider whether Mr Holt's analysis had identified statistically significant relationships?
A. Well, so the -- one would need to go into the detail here, but there are certainly cases where he has a coefficient on his cost which is not statistically significant. So he does not always find a statistically significant relationship.
Q. So you are happy to put forward numbers that are not statistically significant?

A. Well, I make a judgment here. So I think -- I state very clearly that I have reservations with Mr Holt's estimates. So, in general, I find that Mr Holt's estimates tend to be less rigorous than mine, you know, for various reasons, including the fact that he tends to use a much shorter period with fewer observations. He often ends up with coefficients on his costs estimates which are not statistically significant, and sometimes he ends up with results which are just completely implausible.

So what I did was I looked at his estimates for this -- for the other services sector. I did not use all of them. I looked at them and I thought, well, which ones are maybe imperfect, or in fact far from perfect, but are sufficiently robust that I am -- that they are a better option than having no information at all for these sub-sectors? In particular, I chose the cases where he had relatively more observations and produced results which were plausible.

So I will agree that there is an element of judgment here, you know, and generally -- I cannot really say this without sounding rather egotistical, but my general view is that my analysis of public data is much more rigorous and much more robust than Mr Holt's. So I was -- I thought very carefully about this, but I

thought in these cases it was more sensible to use his more rigorous estimates where it was that, or have no evidence that directly related to the relevant subsectors.
Q. So we will look at a couple of examples very briefly, but you put numbers forward that you recognised were not statistically significant on his model?
A. Yes, and I do explain that I have reservations about his results.
Q. You also quote numbers where Mr Holt is looking at data just for 2011 onwards, do you not?
A. Yes.
Q. Did you consider whether those were appropriate for the Merricks claim period?
A. Well, again, I think, you know, we are making the same point, which is that I am not saying -- I am not saying that Mr Holt's estimates are as rigorous as my estimates, I am just saying that in these cases I thought it was more appropriate to use his estimates than to use information from outside the relevant sub-sectors.
Q. We will look at one example. So Mr Holt's analysis of dry-cleaning, you say you are adopting that, which is to adopt a figure of 38% for dry cleaning.
If we go to {RC-F/19/385}. So this is the one you

say you have adopted, which is the 38% figure from dry cleaning. We see, at paragraph A286, that it is the average weekly earnings for other service activities. Then if we go to paragraph -- over the page to paragraph 291, sorry, two pages {RC-F/19/387}, Mr Holt sets out what he has done. We do not need to look at the table, we can just see what he explains. The first number, which happens to be 38%, which is the one you have used. He presents his baseline results for 2011 onwards. Then the second number is -- the second column shows the result if one includes data that covers all period for which data is available. In this case, the data starts in the first quarter of 2001 and the estimated pass-on rate is 28%.

So he has done a calculation for the merchant claim period, 2011 onwards, and that is 38%, and then he has done an analysis which goes all the way back to 2001 and he has a pass-on rate of 28%.

Then if we go down to paragraph 292, we can see that he explains:

"The total pass-on estimate is not statistically significant in any of the regressions at the 10% level, except ..."

The second one, which I think is the second column.

So what he has done is the 38% figure is in relation to data from 2011 onwards and it is not statistically significant, but when he has looked at a longer period of data, it is a lower number, and it is statistically significant.

So why have you adopted his not statistically significant number in relation to the wrong claim period? Is it just because it gives you a higher pass-on number?

A. No, I think it is because -- what I have done is I have adopted the estimate that Mr Holt uses himself, is the approach that I have taken. It is -- 38% is a relatively low number. It is lower than any of the numbers that I estimate for any of my public data sectors.

Q. On Mr Holt's analysis -- I mean, one of your criticisms you make is he does not look at long enough time periods. So when he does his second analysis which looks at a longer time period, which does then include multiple years of the Merricks claim period, you ignore that one, even though that is the one that is actually statistically significant?

A. Yes, as I said -- well, you are asking me why did I adopt the 38%? I used that because that is the estimate that Mr Holt adopts.

Q. That is consistently the case here, that when Mr Holt looks at longer time periods he get lower numbers, and even though that includes the Merricks time period, you adopt the higher ones that are in relation to the wrong time period, do you not?

A. Well, what I do is I adopt Mr Holt's estimates. So I basically agree with Mr Holt to some extent regarding these sub-sectors and adopt whatever estimate he produces for the sub-sector.

Q. Mr Coombs, those are my last questions in relation to the sectors. Just one --

PROFESSOR WATERSON: Can I just raise an issue? You had written about the history of the industry, and Mr Cook has already pointed out, I think, there have been big changes in the industry. Three itself, of course, is a relatively late entrant to the industry, it first started in 2003, so for only two years was it coincident, or probably less than two years was it coincident with Merricks claim period. So you are using it because it is there, rather than because it might relate to the Merricks claim period, really?

A. Yes. I mean, I am using -- I did not myself choose which merchants provided data, that was the result of a process, and the result of the process was that Three provided data, so that was the data that was available for me to use.

PROFESSOR WATERSON: Yes.
MR COOK: The final topic I am going to ask you some questions about is surcharging. Can we go to your second report at page 169 {RC-G/9/169}.
Now, in your first report you suggested that surcharging was actually not permitted in the UK during the Merricks claim period, but you have now, in your second report, corrected that, and realised that actually it was permitted by law throughout the Merricks claim period?
A. Yes.
Q. Now, in relation to surcharging, I suggest to you the particular relevance of surcharging is in the context of cross-border transactions, because if a foreign -- you will appreciate the different aspects of the Merricks claim. So one origin of the Merricks claim is cross-border transactions by EEA card holders, French, Germans, coming here on holiday and using their cards, and that is meant to be the potential source of an overcharge. Obviously if those groups -- if that group was surcharged in relation to those transactions, then that loss is potentially suffered by them, but they are not part of the class in general, are they?
A. That is correct, yes.
Q. So the issue here is whether foreign card holders were

surcharged, and that would potentially make a big difference, because then there is no overcharge to be passed on to UK consumers?

A. For those transactions.

Q. That is right.

A. Yes.

Q. So that is the potential relevance of surcharging.

If we then look at the evidence. At 3.342 there, you refer to a document that was produced by Mastercard international that says:

"... [in the UK] where national legislation has permitted surcharging for the last decade or more. Here, cases of surcharging are limited to environments such as taxis, T&E retailers ..."

That is the classic abbreviation for travel and entertainment.

"... (especially travel agents) ..."

Then over the page:

"... and sporting venues, theatres and cinemas' and on this basis concluded 'very few merchants will choose to implement a surcharge ...'."

But looking at that, the sectors where surcharging took place are ones where you would expect there to be particularly high levels of expenditure by tourists, are they not?

A. Sorry, could we go back over the page, please.
{RC-G/9/169}
Q. So taxis, T&E retailers, so that would be restaurants, bars, hotels and travel airlines and matters like that, especially travel agents, and then sporting venues. The next one, theatres and cinemas; cinemas perhaps a little bit less so. But those are otherwise exactly the kind of categories of merchants that you would expect to have high levels of tourist expenditure, are they not?
A. Well, I think it depends which way round you are looking at this. So you would expect there to be tourist expenditure in these outlets. I would also expect there to be tourist expenditure in other types of outlets as well.
Q. No, I am making a point that you would expect tourists would spend much higher levels of expenditure at those kind of outlets and probably less in Primark?
A. Yes, I would agree with that.
Q. Then if we go down to 3.343, you say:
"... I remain of the view that surcharging was uncommon ... For example, an OFT survey found that in 2007, 81% of businesses in the UK applied no payment surcharges at all."
So turning that around, that suggests that 19% did, and we have seen that that 19% was likely to be very

heavily weighted within those sectors that were particularly relevant to tourists. So looking at that, there clearly is likely to have been significant surcharging of credit card transactions by foreign card holders, is there not?
A. Well, I am not sure that this shows that there would be a significant level. I think what this shows is that there would have been some degree of surcharging, but I do not think it is possible -- well, certainly I cannot, sitting here now, quantify how significant that would be, but there would be some level of surcharging of foreign travellers, as you describe them.
Q. Yes. You simply have not quantified it, have you?
A. No.
MR COOK: Thank you.
Thank you, sir, I have no more questions.
THE CHAIRMAN: Thank you, Mr Cook.
Mr Beal.
Cross-examination by MR BEAL
MR BEAL: Good afternoon, Mr Coombs. Can I give you, please, the usual weasel words, that we have an awful lot of material here and I cannot cover it in the time available, and therefore the fact that I do not pick you up on a particular point at page 462 of your second report -- fourteenth report, does not mean that we

accept it.

A. Sorry, could you repeat that?

Q. I am just giving the standard warning I give to every expert when we are time-constrained, that I am not going to put every point to you, and just because I have not, does not mean that it is accepted, what you say.

A. Okay.

THE CHAIRMAN: I think it is more for our benefit.

A. Okay.

MR BEAL: I think that is fair.

Can I also assume that if there is anything from your reports 1 to 12 that was considered to be material and significant, it would have found its way into the thousand pages we are looking at?

A. It would have -- well, either it would find its way indirectly or it would be cross-referenced.

Q. Now, could we look, please, in your thirteenth report at paragraph 1.15 {RC-F/10/10}. You are relying here on some evidence that was given by Dr Niels and Mr Harman in the *Sainsbury's* case. Somewhat unusually, perhaps, Mr Cook for Mastercard has already pointed out that Mastercard lost that case. But the point I would like to ask you about is did you consider the countervailing expert evidence that was given on behalf of Sainsbury's?

A. No, I did not.

Q. Did you consider flagging in your report, in the light of the fact that Mastercard was not successful and therefore Sainsbury's was, that you had not taken into account the countervailing argument? Did it occur to you to point that out?

A. No.

Q. Could I then please ask you look at paragraph 1.13 in this report, page 8 {RC-F/10/8}. You say there that you have considered the empirical evidence. Can you see that?

A. Yes.

Q. But it is not correct, is it, that you have looked specifically at the way that the analysed claimants, the SSH claimants, provide witness evidence, other than Three?

The only one of the SSH claimants who have provided witness evidence that we have heard that you have looked at is Three?

A. Sorry, I am getting a bit lost here. So you are referring to the witness evidence rather than the data that has been provided --

Q. You say:

"... as well as a substantial amount of empirical evidence."

The empirical evidence obviously encompasses not simply public data, but also the witness evidence that has been provided by large companies that operate in the retail sector?

A. So I think I refer to some of the witness evidence that has been provided by other merchants, not just Three.

Q. Well, we will look at that. I think the only one that you have cited apart from Three is Travix, but I will come on to look at that in a moment.

Did you consider the data that had been provided by all of the merchant claimants?

A. No, I did not.

Q. You are not seeking to determine a specific pass-on rate for a specific SSH claimant, are you?

A. No. So my instructions are to provide my opinion on pass-on that is relevant to Mr Merricks' claim. So it is a UK economy-wide or retail economy-wide pass-on rate, not the pass-on rate that is specific to particular merchants.

Q. That is for the purchase of goods and services for Mastercard transactions only, is it, not Visa?

A. Ultimately, yes, but -- well, I mean, maybe to be clear, I do not attempt to estimate a separate pass-on rate for Mastercard transactions and for Visa transactions. I think my approach was to assume that they were most likely going to be the same.

Q. But you end up therefore not suggesting that there would be a specific pass-on rate for any specific SSH claimant in the period from 2011 through to 2024?
A. That is correct, yes.
Q. Could we look, please, at paragraph 1.17 of your thirteenth report, page 10 of this report {RC-F/10/10}. You say here that for practical reasons you need to perform the analysis at a high level of aggregation. Is that fair?
A. Yes.
Q. Having performed that high level of aggregation, you end up in a position, do you not, where you settle upon ultimately a figure of 91% as a UK sector-wide pass-on rate?
A. Yes.
Q. You invite this Tribunal to apply that not necessarily to the SSH claimants but to the Merricks claim?
A. Yes. Well, I suppose maybe I should be careful not to overstep the mark here. All I am doing is presenting my evidence to the Tribunal. It is up to the Tribunal to decide what to do with my evidence.
Q. You are not suggesting that that 91% figure that otherwise rules the law is appropriate for a given SSH claimant?
A. No.

Q. Indeed, as far as I understand it, you are not even suggesting that that figure of 91% is appropriate for any business sector in which an SSH claimant may find itself?
A. No. I suppose, to be -- well, to state of the obvious, obviously I have estimated pass-on rates on a sectoral basis, so I provided estimates for 12 different sectors, but ultimately I am using those as inputs to calculate an economy-wide pass-on rate. That is the purpose of calculating those sectoral pass-on rates.
Q. In terms of those 12 sectors that you are talking about, it is fair to say that that was not based on an analysis of the individual characteristics of certain of the SSH claimants?
A. Sorry, I do not quite follow the question.
Q. The sectorisation method you adopted was unrelated to the composition of the SSH claim. It was not something you were looking at?
A. No. I think this was explained yesterday, and it is explained in the report. So the approach I took was I need to calculate a pass-on rate for the UK economy and it needs to be relevant to Mr Merricks' claim period and, given that I am estimating pass-on rates for each sector, and then I have to calculate a weighted average of those sectoral pass-on rates, I need weights, sector

weights, and the only information that I could find on sector weights was the information from the UK Card Association, and so that determined my choice of sectors, my choice of 12 sectors.

I would note, in passing, that I think I identified that there are -- each of those sectors has at least one, I think in every case actually multiple SSH claimants in the sector. But that was not the basis on which I designed the sectors, it was designed so I could calculate the UK economy-wide pass-on rate.

Q. I thought that was not true for household, but someone will correct me at some point if that is wrong.

What you have not done, though, is the exercise that Dr Trento has done, which is to try and establish the top ten or so sectors by claim value by reference to the SSH claim; correct? You have adopted a different approach, as you have just explained?

A. Yes.

Q. Now, could we look, please, at the 12 sectors you have covered based on the card data you have described. This is, please, paragraph 1.18 of your thirteenth report, page 10 {RC-F/10/10}. You there give the 12 sectors and say what they are.

What does household cover?

A. So household. Well, I think we went through this with

Mr Cook, that household covers -- well, the largest elements are DIY, furniture and consumer electronics, from recollection, and then there are a number of other sort of related products.
Q. In contrast, automotive fuel seems pretty narrow and specific, does it not?
A. Yes, I think -- well --
Q. It largely covers petrol stations?
A. It covers petrol stations, yes.
Q. Other retail is, in contrast, very broad?
A. Yes.
Q. Other services is even broader?
A. Well, yes, other retail and other services are both very broad. They are -- I think, as Mr Cook correctly identified, essentially what the Card Association does is it identifies the largest sectors, and then it is left with some residual which, you know, covers a lot -- a wide range of different types of activities.
Q. Which categories would universities fall in?
A. So universities would fall within other services.
Q. At 1.19 of this report, so further down that page, you refer to "willing claimants". Why are you calling them willing claimants? Are you suggesting that some claimants were unwilling?
A. I think, well, I was reflecting the language that I had

used by others in this case, that we were trying to -- well, I say "we" -- the Tribunal was trying to identify with the help of yourself and your colleagues the claimants who were willing to provide data. I think the approach that was taken at the January hearing was to identify something like the ten largest claimants or something like that, and then talk to those claimants and find out whether they would be willing to provide data, and that is how the selection was made, although it actually ended up with more than ten.

Q. Regardless of whether or not they are representative of the UK economy, you would accept on that basis at least that prima facie they are representative of the constituency of the SSH claim itself? If you pick the ten biggest claimants by value and by entity number, then you are likely, on balance, to have the representative sample from that claim; no?

A. Well, I am not sure that follows, but I mean I think it could be the case, but obviously the fact that -- you know, it could be that the ten largest might all be, you know, in one area and not representative of another area, so I am not sure it actually follows.

Q. They have chosen the ten biggest sectors and then picked, ideally, the biggest claim within that sector, subject to negotiation between the experts; correct?

I do not think you were party to that bit of horse-trading at the time.
A. Possibly not, no.
Q. Could we look, please, at page 12 at table 1 in your thirteenth report {RC-F/10/12}. Under category 4 we have hotels, and you say previous studies deal with hotels, suitable public data deals with hotels, merchant data used receives the not applicable.
Now, is it not applicable, is it not, because you chose not to use the Hilton data?
A. Yes.
Q. That Hilton data would have given you a very disaggregated and detailed dataset, would it not?
A. Well, the reason -- so the approach I adopted was that where I had suitable public data, then I used the public data rather than the merchant data. I only personally used the merchant data to fill in the gaps, so to speak, in areas where I did not have suitable public data. So that is the approach that I adopted.
Q. At the risk of bigging up my own client, Hilton is a pretty big player in the hotel sector, is it not?
A. Yes.
Q. Therefore, this would have been a perfect opportunity for you to conduct some sort of analysis to see whether or not the figures that you were producing for the

sector as a whole were implausibly large compared to the very disaggregated data that was available for Hilton itself?
A. Well, I suppose there are two points I would make. The first is that, you know, given the limited time available to prepare my report for this trial, I had to sort of prioritise what I was going to do, so I prioritised on the basis I just described, that where I had public data I used public data, and I only used the merchant data to fill the gaps.
Secondly, in terms of --
Q. Can I just pause you there. It is right, is it not, that the other experts, given the same timeframe, were able to produce analysis of Hilton's data?
A. Well, other experts analysed different merchants from me. So some of them analysed merchants that I did not analyse and some of them did not analyse merchants that I analysed. So there was a difference in approach in terms of how we prioritised the merchant data.
Q. Could we then please look at category 11 on your table --
A. Sorry, I was -- you interrupted my answer.
Q. I am sorry. Please.
A. The second point I was going to make is that is obviously the reason I took the approach I did was that

my concern was that data for an individual merchant relates to that particular merchant, and then if one wants to apply that to the sector, we have to go through the step that Mr Cook has interrogated me on in terms of: is it appropriate to take data from that merchant and apply it to rest of the sector? So that is something that I sort of thought about on a case-by-case basis.

Q. Why did you think Hilton would be unrepresentative of a hotel sector when it is such a big player in that sector?

A. Well, I took the view that I had public data for the hotel sector and, as I say, where I had public data I prioritised the public data over the merchant data.

Q. So it is nothing to do with whether or not a particular company was representative or not, you just thought public data equals good, merchant data equals bad, and I am going to use the public data?

A. It was a bit more than that, because then in situations where I said there were some situations where I did not have suitable public data, even then I did not just automatically use the merchant data that was available, I looked to see whether data from that merchant was likely to be representative of the sector before deciding whether to use that data or not.

Q. Then at item 11 on this, we have other retail, which I think Mr Cook KC described as being your hybrid or mixed approach, where in part you are relying on public data for jewellers, is that right?
A. Yes.
Q. In part you are relying on the merchant data for Pets at Home, even though Pets at Home was not one of the entities that provided detailed witness evidence in this case?
A. Yes.
Q. You have ended up picking a figure that is derived primarily from a combination of tobacco and office furniture -- no, sorry, I beg your pardon, you have not factored in studies, so this is a straight fight between jewellers and Pets at Home, is that right?
A. It is not really a fight; it is an average between the two.
Q. Is it fair to say that the concept of a jeweller also offering pet shop goods is quite unusual, unless one has, I do not know, diamond-studded dog collars?
A. That is not the approach that I am using. As I say, I am using the average between the two, because I am saying I have evidence from two different sources for this sector and I take the average between the two. I am not suggesting that retailers in this sector are

all selling both jewellery and pet food.

Q. But the consequence of that average approach would be if you leveraged that into a figure for Pets at Home, which is a designated claimant, you would be giving Pets at Home a higher pass-on rate as a result of the average than you had yourself ascribed to it as a claimant?

A. Yes. Well, I think -- I mean, just to be clear, and I think maybe you were clear, but I will just repeat it. I am not proposing that any of my estimates should necessarily be mechanically applied to any of the merchants in the sectors. That is not the exercise I was undertaking.

Q. So can I put it this way: your temperamental preference is to conduct regression analysis on the basis of public data, save where you think you cannot do that?

A. Yes.

Q. But of course that public data does not extend, does it, to a consideration of the MIF overcharge paid by specific SSH claimants?

A. I think your point -- the point you are making is that for any individual merchants within a sector, the pass-on rate for that individual merchant might be different from the average for the sector. If that is the point you are making then, yes, that must be correct.

Q. No, the point I am making is that none of the public data drills down into the specific independent variable being the MIF overcharge.
A. So it is --
Q. The regression of the public data is not going to yield a figure, is it, that relates to the very thing that we are asked to look at in the SSH claim?
A. So I think that all the experts in this case are agreed that it is not possible to directly estimate the pass-on of the MSC, and that is why we are all using some other measure of cost as a proxy for the MSC. So that is what I am doing, and my understanding is that is what all the experts are doing.
Q. Can I just qualify that. Mr Murgatroyd, for example, tried to and thought he could establish that in fact the data showed, on a regression analysis of Allianz's data, no correlation.
A. Well, okay, so I was referring to all the experts who are, you know, still present in this case. You are correct to say that Mr Murgatroyd did try to make an estimate, but my view, and I believe it is the view of all the other experts who are still present in this case, is that that approach is bound to fail. It was discussed in the hot-tub that there is a signal to noise ratio that means that you cannot actually identify the

pass-on of the MSC itself.
Q. Regression analysis generally is only going to show a correlation between the dependent variable and the independent variable; correct?
A. Well, it will -- it measures correlation. It may also provide some information about causation, depending upon how you construct the analysis and so on.
Q. If --
A. But, yes, it directly measures the correlation.
Q. If the model that is produced is subject to inherent imprecision, it is not going to give you a very useful answer for any of the issues that are before this Tribunal, is it?
A. Well, there is always a degree of imprecision in econometric analysis, so I would agree with that, yes.
Q. Could we look in your thirteenth report, please, at paragraph 1.24(b)(ii) at page 14 {RC-F/10/14}. You have essentially derived, have you not, a composite cost index from a variety of different sources?
A. Yes.
Q. In certain circumstances that is a measure of what I would describe as cost of goods sold, such as PPI; correct?
A. Yes.
Q. In some circumstances, but certainly not all, you have

factored in import PPI?
A. I have not actually used import PPIs, because import PPIs tend to -- well, in all of the cases I examined they were only available for later years, and therefore I did not -- I was not able to do the analysis using import PPIs because it would have drastically reduced the time period I would have analysed.
Q. You have also used the labour cost, such as AWE?
A. Yes.
Q. I will come on to deal with the detail of this in due course, I am just trying to get the parameters of the exercise that you conducted at the moment.
So you are in a position where essentially you are looking at a cost index and a price index and seeing whether there is a correlation between the two?
A. Yes.
Q. If the cost index in fact is measuring different things from the price index, then that is going to cause a bit of a problem, is it not?
A. Well, it creates a situation where you have some mismatch between the cost and the price index, and so therefore that is going to in some ways affect the regression, yes.
Q. But I am not sure I -- my economics education is relatively modest, it is A level only. I did not have

three years doing undergraduate or a PhD. But as an educated guess, the suggestion that if a general set of costs for a business increase, that it may over time increase its prices, if that is what your study shows, that is not going to be terribly informative, is it? How is that different from what one might intuit as a common or garden member of the public?

A. What I am trying to do is measure the degree to which the cost is passed through, so you can --

Q. Your cost proxy in each case is total costs, is it not?

A. Yes.

Q. So you are looking at the extent to which the total costs faced by a business are, in the long-run -- to be discussed -- are, in the long-run, reflected in prices charged by the business?

A. Yes.

Q. What I suggest to you is that that is not terribly helpful in establishing whether or not there has been an increase in the MIF which has led to an identifiable increase in prices charged by my claimants.

A. Well, I believe it is.

Q. Now, you cannot really complain about the representativeness of the sample of the analysed claimants, have you -- can you, when you have not used all of the data?

A. Well, sorry, I do not really quite follow the logic there. So what I have done is where I lacked public data, I have looked to see if there was a merchant whose data I could use and, if there was, then I have used it. So that is the approach I have taken. I am not really quite sure -- you are suggesting that I cannot complain about the fact that the merchant data that is available in this case is not representative of the sectors that I am looking at, but I think I can still observe that the merchants might not be representative of the sectors that I am looking at.
Q. Well, can we imagine a world in which the Merricks claim had not been joined with the SSH claim; you would not have had any of this data, would you?
A. No.
Q. So does it not smack of ingratitude to be complaining about suddenly being given it?
A. Well, I am not sure I am complaining about anything; I am just observing that this is the approach I have taken. That the approach I have taken has been to recognise that data from an individual merchant might not be as representative of a sector as public data that covers the whole sector is. So it is an observation, it is not a complaint.
Q. Can we look, please, at page 15 of this report,

paragraph 1.42(c) {RC-F/10/15}.

It is right to note, is it not, that you have only been looking at the impact on consumer prices, not on business prices?

A. Yes.

Q. So your analysis does not capture business to business sales that may have been made by any of the SSH claimants?

A. Yes, that is correct.

Q. Can we look at 1.24(d), please, which is page 16 {RC-F/10/16}. You say there you have modelled VAT changes into your pass-on rates and that you have used an economy-wide effective VAT rate, but I think you have accepted in evidence, in response to the questioning from Mr Cook KC, that different sub-sectors may have very different VAT positions?

A. Yes.

Q. I think your report actually notes that the insurance sector, for example, will be a largely exempt business for VAT purposes?

A. Yes, so -- well, financial services in general are exempt from VAT. Insurance is subject instead to insurance premium tax.

Q. Of course, you are looking at this from the perspective of the consumer who is having to either pay VAT on the

final price or not; correct?
A. That is correct, yes.
Q. You are not looking at the input tax recovery from the business?
A. No.
Q. So where, for example, financial services under the specified supply order get back any investment, for example, in foreign equities or bonds, you would not -- that does not get factored into your effective VAT rate, does it?
A. No.
Q. But it would be a big difference for the business, because it would not be looking at having to pay the entirety of the VAT over to HMRC?
A. That may well be the case, yes.
Q. Can we look, please, at page 122 of this report, paragraph 3.208 {RC-F/10/122}. You, I think, tell me if I am wrong, I think on grounds of consistency, you then factored in VAT into your price cost ratio when converting elasticities into pass-on rates?
A. Yes.
Q. Was it for consistency?
A. Sorry, I am not sure I follow the question.
Q. Well, the point I am putting to you is the calculation of a price-cost ratio with a VAT rate on top, based on

the underlying cost, is going to elevate the price-cost ratio; correct?
A. Yes.
Q. Other things being equal. That may not be an appropriate step when you are looking at the pass-on from the business's point of view, because from the business's point of view it may or may not have been paying the full rate of VAT, given its input tax recovery?
A. Yes.
Q. That leads to arguably a different and therefore higher pass-on estimate from the point of view of the consumer than you would get if you were looking at this simply from the perspective of one of my clients as a business?
A. Yes.
Q. VAT, as I understand it, is not included in the cost measure indices you use, is it?
A. No.
Q. But it is included in the price indices?
A. Yes.
Q. So when you use a comparison between a cost indices that does not have VAT and a price indices that does, you are having to build up the difference by applying the effective VAT rate on a UK-wide basis?
A. Yes.

Q. Again, we have established, I think, that that would give unduly high results for any sector where VAT was simply not an issue?

A. Yes, and of course might give an unduly low result, given I am sort of using the average across all sectors. For some sectors it will be too high and for some sectors it will be too low. For the purpose of Mr Merricks' claim, as I said, that should all cancel out. But I agree with I think where you are going, that for an individual merchant in an individual sector, that might not be representative of their situation.

Q. Yes, and to be fair to you, when you have used individual merchant data, you have simply taken their VAT treatment as read. You have not sought to apply the effective UK-wide VAT rate to it?

A. Yes, that is correct.

Q. I think I can put you out of your misery on pet foods with Pets at Home. Schedule 8 of the VAT Act excludes animal feed stuffs, but with an exception for pet food. So Pedigree Chum, etc, is standard-rated, animal feedstuffs is zero-rated, but I do not think the case is going to turn on that.

Could we look, please, at paragraph 1.24(f) at page 17 of your thirteenth report {RC-F/10/17}. I may have this wrong, but certainly at this stage, looking at

the first sentence, one possible implication is that you were only looking at data up to 2010 and were not really looking at anything after that. But in reality, I think what you have done is you have looked at the later data and then extrapolated backwards, is that right?
A. Sorry, can I just read the paragraph here. (Pause)
Sorry, could you repeat question.
Q. The impression one gets is that you may not have data for the earlier periods, you have not dealt with data for the later periods, but I understand from what you have done in practice that you have looked at data from later periods and then read it backwards in time as well; correct?
A. Yes.
Q. So you are reading -- the data you do have for the Merricks period, you are reading that back to 1992. But then separately are relying on non-Merricks data to read back to support your case as well?
A. Yes.
Q. I just wanted to get --
A. I would not -- you say "support your case". I am not making a case here, I am just providing my best estimate --
Q. I am sorry, it is a lawyer's habit to think of everyone as in one camp or the other.

Could we look, please, at 1.27(b), report 13, page 18 of this document {RC-F/10/18}. Here you are saying:

"In industries with price regulation, the pass-on rate depends on the price setting mechanism provided for by the regulation. [You did] not use evidence on price setting mechanisms in regulated industries ... because the way in which costs are treated in regulatory pricing decisions in those industries will be implicitly reflected in the pass-on rate ..."

So I understand that to mean that where you have a sort of bottom-up approach to what price can I charge, that will necessarily build in the costs, and those costs will then build in an accepted margin and that provides a regulated price. So the standard way of dealing with Openreach, for example. Is that what you are thinking of?

A. Yes.

Q. That does not work, does it, for a top-down regulated price such as for university student fees?

A. Yes. So university student fees are regulated in a very different way from a utility such as Openreach, yes.

Q. I think we have established you have not looked at universities, so you have not looked at the consequence of that type of price regulation?

A. No, I have not.

Q. Could we then please look at page 19 and Table 2 {RC-F/10/19}. As I understand it, this sets out your overall sectoral conclusions as modified by the later report, but I am not going dive into the detail here, I am simply looking to pull out some general points.
What this shows, does it not, is that there is a substantial degree of variability between the figures derived from previous studies, public data, and, where applicable, the merchant data?
A. Yes.
Q. Looking at 7, item number 7, you seem to have triangulated some of these figures for the far right column -- well, let me check whether I have this right.
As I understand it, for item 7 you have given an indicative pass-on rate from the previous studies which is 71 to 88%. Is that right?
A. Yes.
Q. From public data, it is 111% or so?
A. Yes.
Q. Then from merchant data, we see the variety of pass-on rates there.
Is the 79% figure on the right-hand side a product of columns B and C or is it a product of columns A, B and C?
A. It is a product of columns B and C, and I think we

earlier explained exactly how I used these numbers to produce the number on the right-hand side. But I think you are not asking about the detail, you are just saying that the inputs are from B and C and not from A.
Q. So even though this is a sector which does not have suitable or sufficient public data, you are producing a weighted average, to be discussed how that weighting works if we need to. You are producing an average, nonetheless, between that unreliable data and the data provided by the merchants which has enabled you to reach, at least at face value, an estimate that you think will help the Tribunal?
A. I am not quite sure what you are -- you are referring there to unreliable data --
Q. You are relying on an unreliable statistic, because this is in a sector without suitable or sufficient public data, and you are then aggregating that and dividing it by a particular weighting, notwithstanding that it is derived from sectors which do not have suitable or sufficient public data?
A. Well, no, that is not correct. So vehicle sales and services, so there are -- I think we have already been through this but there are two parts here. There is vehicle services and there is vehicle sales. So there was public -- suitable public data was available for

vehicle services. Suitable public data is not available for vehicle sales because of the import issue. So therefore I have a reliable estimate for vehicle services, I do not have an estimate from public data for vehicle sales.

Q. So why did you not separate out item 7 so that it read 7(a) and 7(b) to reflect that particularly important finding?

A. Well, obviously that detail is in the report. This is a summary table where it just sets out the sources of data that I have used for each of the sectors. This is not intended to explain all the detail of my analysis.

Q. Now, did the high degree of variability between these figures give you any pause for thought?

A. I mean, I think it is not surprising to find that there are differences in pass-on rates across different sectors. It is not surprising to find that there are differences in pass-on rates based on different sources of data. I do not find that necessarily surprising.

Q. At item 11 here, we see, put into percentage terms, the point I have made to you earlier, and which you accepted, as I understand it.

If we go on the sector for other retail, then there is a figure for Pets at Home, which is 55% that you have reached, but the overall sectoral conclusion that you reach is 82%. So if at Pets at Home is not given an individual rate, it is landed with a figure that is somewhere around 27% higher than it would be otherwise?

A. Well, I am not suggesting that this number should be applied to Pets at Home. That is not what I was instructed to estimate. What I am estimating is a pass-on rate for this sector, which is then an input for the pass-on rate for the retail economy. So I am not suggesting that this pass-on rate of 82.1% should be applied to Pets at Home, no.

THE CHAIRMAN: So you have applied the public data amount to get to that average, B and C; yes?

A. Yes. In the case of other retail, D is the average of B and C, is the simple average of B and C.

THE CHAIRMAN: But this is also below the comment that these are sectors without suitable or sufficient public data, is that right?

A. Yes, so maybe -- yes, maybe the heading here is not sufficiently clear. So what I am saying is that for these sectors, there is not suitable or sufficient public data for the sector as a whole, but in the case of vehicle sales and services and other retail, there is public data available for a sub-sector within the sector. So apologies if that is not clear.

PROFESSOR WATERSON: Would vehicle services also include

imported materials; in other words, parts that are fitted that come from other countries?
A. I expect it would, yes, although in practice the cost measure I use is the wages, rather than the cost of the inputs.
PROFESSOR WATERSON: Right, okay.
MR BEAL: Could we look, please, at paragraph 3.221, which is at page 124 of this report {RC-F/10/124}. Again, here, in terms of calculation of pass-on rates, you say you triangulate the estimated pass-on rate from public data analysis with evidence from previous studies and, where applicable, merchant data analysis. Just pausing there, that at first blush would make it look as though you were doing the exercise Mr Holt had adopted, of adopting an average of averages across three different sources. But I think it is right, is it not, that your approach is nuanced, in the sense that you have used public studies, ie empirical studies, academic articles, in a sense to provide low level support, or high level support, depending how you want to put it, but you have not actually triangulated a percentage figure from those studies into the final figure?
A. Yes, that is correct.
Q. So for any given outcome, for any given sector, your primary and preferred approach is to use regression

analysis based on public data estimates; correct?
A. Yes.
Q. Where the public data is not good enough, you either bolt on merchant data to help with a sub-sector of public data; correct?
A. Yes.
Q. Or you rely on merchant data and then do the best you can with it?
A. Yes.
Q. When you looked at the assistance you were getting from academic studies, you did not weight your averages to reflect the degree of precision or imprecision in the studies themselves, did you?
A. No.
Q. But you would accept, if you were relying on the percentage to drive the final estimate that you were recommending to the Tribunal, that sort of meta-analysis should be done, should it not?
A. Yes, I think -- well, I agree with the point you make that there is a distinction between what I did, which is just use this as a cross-check and background information, as opposed to if one were to actually use it as an input, then you might want to do more with them. I may be -- I am not going to sort of say necessarily you have to do a meta-analysis, because, you

know, I do not really have to think about that, because I am not actually using the data in this way. But if I had been using the data in that way, then I think I would have thought a lot more carefully about how to use the data from the previous studies.

MR BEAL: That is perhaps a convenient moment before I move on to the role of economic theory.

THE CHAIRMAN: So you were using studies as a sort of cross-check, were you?

A. Yes, exactly.

THE CHAIRMAN: So what happens if the studies were sort of a bit -- well out of line with the rates that you come up with from the public data and the merchant data, did that change things?

A. Well, I think in -- well, I think the answer is that I did not find the results I was coming up with were completely out of line. I suppose the one sector where you might say that was the case was the household sector, where the estimate I came up with is higher than the estimates that you find from public studies, and I think we discussed this yesterday, the issue with the public studies is that they are from other countries and they study basically exchange rate impacts, so the impact of imports, and that is -- it is therefore difficult to interpret the results, because they are specific to what is the impact of changing an import cost rather than changing the cost -- other costs. It is also not necessarily that relevant to the UK furniture sector where imports are a relatively small proportion of the market.

THE CHAIRMAN: Alright, thank you. We will take a ten-minute break now.

(3.08 pm)

(Short Break)

(3.18 pm)

MR BEAL: Mr Coombs, do you accept that economic analysis should follow commercial practice?

A. I am not really quite sure what that means. I think what I would say is that economic analysis should take account of relevant facts.

Q. Can I ask you, please, to look in {RC-J1.4/53/65}. This is the RBB report from 2016, paragraph 104. Let us see whether you agree with this statement from RBB in a report with Cuatrecasas. Page 65.

You will see there the authors say:

"Nevertheless, it is essential that economic analysis is practically minded and responds to and is consistent with the factual and other evidence pertaining to an individual case. The economics must 'fit' with the relevant market context."

You would accept that, would you not?
A. Yes.
Q. You have nonetheless relied on general economic theory for certain incentives, is that fair?
A. Well, I have -- I have looked at what economic theory tells us about pass-on. I would say that that is what I have done.
Q. Can I try and summarise what I think is your approach at a very general level. So you say firms have an incentive to pass on variable costs in their pricing decisions?
A. Yes.
Q. You say in the long-run, all costs are variable in the sense that they can be influenced by firms?
A. Yes.
Q. In the long-run, you say firms must cover all their costs or go out of business?
A. Yes.
Q. You then say UK retailers operate in very competitive markets, so you say they have little margin to absorb merchant service charges?
A. Yes.
Q. It follows, therefore, that merchant service charges must be passed on over time, regardless of whether or not it is a variable or fixed cost in the short-run?

A. Yes, although I would say it is -- that they clearly are a variable cost in the short-run.
Q. We have ascertained, I think, have we not, that the long-run in your estimation can be somewhere between 13 years and 40 years, based on the evidence with Mr Cook yesterday?
A. Well, when I am talking about the long-run, what I am saying is I am saying that the Merricks period is longer than the long-run, so therefore, in terms of estimating pass-on for these purposes, one is thinking about the long-run.
Q. So when we have said in our skeleton, quoting from Maynard Keynes, that in the long run, everyone is dead, you are not asking to take us literally at that; you are happy to have a shorter long-run period that is restricted to the length of the Merricks claim?
A. Yes.
Q. Now, on that analysis, would every firm not have an economic incentive to pass on costs which would lead to your implication that it had done so over the long-run?
A. Well, it depends on the circumstances. It depends, for example, on the level of competition in the market as well as other factors.
Q. You are assuming a very competitive market. That is one of the incentives I put to you, or one of the factors

I put to you.
A. Yes.
Q. So if you keep that assumption constant to enable the analysis to take place, it would follow, would it not, that the competitive intensity of the market is a given, and therefore for anyone in that retail market they would have an incentive to pass their costs in full or risk going out of business?
A. Yes.
Q. So why are we in a position where you have restricted your magic number to 91%? Why do you not say it is full pass-on, because the ambit of enquiry is sufficiently long-run that they must have passed on all their costs or they would be out of business?
A. Well, because what I have done is I have said -- I have not suggested that one should calculate a pass-on rate in this case based on economic theory. I have said economic theory creates some prior expectations about the pass-on rate. So economic theory creates the expectation that, if a market is very competitive, you would expect a high pass-on rate, close to 100%. But one has to actually -- well, ideally one wants to actually analyse the facts and the data in order to estimate what the actual pass-on rate is, because obviously it depends on the exact circumstances of the

market.

Q. But it is a logical conclusion, is it not, from your picking 91% as the magic number for the UK-wide economy, that 9% of total costs have not been recovered, therefore, in the period from 1992 for firms that have stayed -- lucky enough to stay alive for long enough, from 1992 onwards to the present day?

A. Yes, so -- well, first of all I have not picked a number, the number is the estimate that is produced from my analysis of the data, is the first thing. Then maybe two additional points. One is that I would not necessarily expect the pass-on rate to be exactly 100%. As I say, it depends on factors. So I found evidence suggesting that retail markets in the UK are highly competitive with relatively low margins, but there may be some variation between different markets and different sectors, so it might not be that all sectors are sufficiently competitive that you would end up with a pass-on rate of 100%. Also there are, you know, limitations to the data that we have discussed, and some of those limitations may mean that I have underestimated the pass-on rate.

So, you know, there are various reasons why, you know, I would not necessarily expect to come up with an estimate which is exactly 100%.

Q. But it follows from your conclusion that for any company that has survived for the 32 years from 1992, that cohort of companies will have, year-on-year, on average, failed to recover 9% of their total costs, yet they are still in business?

A. Yes. So maybe some of those companies were in less competitive markets than others, for example.

THE CHAIRMAN: Can they not recover those costs in other ways, reducing other costs or --

A. Possibly, yes. But what I have been estimating is the pass-on of costs into prices. So they may have found other ways to recover those losses but that is not something that I have been investigating.

MR BEAL: Now, reliance on economic theory alone can yield some pretty unworldly propositions, can it not? Can we have a look at paragraph 2.14 of your thirteenth report {RC-F/10/30}. You are positing there perfect competition with just two suppliers, but that requires a series of caveats as to the situation in which that would hold true which is just unrealistic; correct?

A. Sorry, which paragraph are we?

Q. Paragraph 2.14. You say you can have perfect competition with just two suppliers:

"This occurs when both suppliers offer a homogeneous product, have identical costs, face no capacity

constraints and compete on price."
What I am putting to you is that is not a set of real world factors, is it?
A. I am not suggesting that -- well, that could exist in some markets, but I am not necessarily suggesting it does exist in all markets. I am saying, you know, this is what you would expect in those situations, but the point I may be repeating is that I am saying that I am not trying to say that you can use economic theory to determine the pass-on rate, I am saying one should investigate the data.
Q. In paragraph 2.17 of this report, further down that page, you suggest different ways of looking at oligopolistic competition, is that fair?
A. Yes.
Q. You alight on the Cournot model. Did you consider the Bertrand differentiated product model for oligopolistic competition?
A. No, but it -- well, that model often tends to come with results which are very similar to the Cournot model.
Q. But the differentiated product market would be a better fit with my clients, would it not, the markets they face?
A. Well, that is an interesting question. You are saying that the -- that they are -- that they are providing

a differentiated service?
Q. I am saying none of them have said in terms: we simply take a price from the market and then decide what quantity we supply. Each of them say that they make a conscious pricing decision for their differentiated products to set prices at certain levels.
A. So I think -- well, I think what we are discussing here is we are discussing a situation where there is imperfect competition, so we are not discussing a perfectly competitive outcome, and in that context what I am saying is I am saying, well, you know, the pass-on rate could be less than 100% in those circumstances.
Q. Yes, but the theory of imperfect competition you have alighted upon is one in which there is competition in quantity, not price?
A. Yes.
Q. Can we then move on to look at the relevant factors that you think are important for considering the MIF or the MSC overcharge as a cost. Could we start, please, by looking at the Commission guidance in this matter at {RC-J1.4/19/14}.
What you see there under recital 51 is a series of factors which are taken into account. Can you see that?
A. Yes.

Q. So they include whether costs are fixed or variable. That is (i).

A. Yes.

Q. Whether the costs impact on all or the vast majority of the customers in the market, (i)?

A. Yes.

Q. Nature of demand that direct or indirect customers face, that is (ii). Strengthening intensity of competition. Then in (iv), a series of other elements that are broken down. So we see price adjustment costs, proportion of the firm's cost affected by the overcharge, buyer power, vertical integration, price regulation or the timing of pricing decisions undertaken at various different levels.

So all of those are factors that you would accept are relevant; correct?

A. Yes.

Q. They are broadly reflected in your thirteenth report, please, {RC-F/10/26}, paragraph 2.4.

Just looking at those factors, please. The first of those you identify is intensity of competition. Now, in terms of intensity of competition and your margin analysis, as I understand it, you have not routinely examined the retail margins for the SSH claimants, have you?

A. No.
Q. In terms of demand and supply, under (b), you have not looked at demand and supply curves for the various sectors?
A. No. Sorry, I am actually just going back to the previous answer. I mean, it is relevant that when -- we went through the analysis with Mr Cook, but I looked at information on margins in the European retail sector and drew some conclusions from that, and as part of that analysis I did compare those average European margins with margins of specific claimants in this case.
So maybe I should just qualify the answer by reminding the Tribunal that I did that, but what I have not done is I have not done something which encompasses all of the SSH claimants. It was only the data providers that I looked at.
Q. Looking -- moving on, then, please, to the nature of the costs. You say these costs are market-wide costs, do you?
A. Yes.
Q. You say that would apply to a company such as Three, even though it has a very high level of direct debit payments from its customers?
A. Yes. Well, the relevant question is not the proportion of Three's customers who are paying by credit card, the

relevant question is Three and its competitors.

Q. The next issue is variable versus fixed costs, and you are aware, are you not, that for all but two of the analysed claimants the MSC is treated as an overhead?

A. Well, I think it is important to distinguish here between different concepts. So there is the economic concept of whether a cost is variable or fixed, and that is a factual economic matter. So either the cost varies with output or it does not.

There is separately the question about how a merchant categorises a cost for its own business purposes. So it might categorise a cost as an overhead, but the fact that with a stroke of a pen it puts that cost category under overhead rather than under COGS does not change the facts or the economic nature of that cost. That cost is still a variable cost, even if it is categorised as an overhead.

Q. But we have accepted, and I will come on to deal with this, that overhead costs can be a mixture of fixed, variable and semi-fixed or semi-variable, depending on one's language. So I do not think we need to have a discussion about that.

I will come on to deal with your suggestion that we have treated the MSCs as fixed costs, because that is not right, but that is for later on.

Just looking at the next item here, ad valorem versus per unit costs. I think you would recognise that certainly for the SSH claim period, the bulk of the MIFs are going to be ad valorem, is that right?

A. Yes.

Q. You there mention VAT, but of course VAT at 20% is going to be a significant factor higher than the 0.2% figure for debit card MIFs; correct?

A. Yes, but it may be relevant to look at changes in VAT that may be informative about how an ad valorem cost is passed on.

Q. Well, we will come on to deal with this.

Did your sector-wide VAT rate, while I think of it, factor in the changes in the standard rate, from 17.5% to 15%, back up to 20%, at any stage?

A. Yes. So it is the effective VAT rate over the period I am looking at.

Q. Moving on to price adjustments, which is under your (iv), page 27 {RC-F/10/27}. As I understand it, you say menu costs or price adjustment costs are not likely to be a significant factor in the long-run that you are looking at; correct?

A. Yes.

Q. Now, size of the cost -- size of the cost change at number (vi). You say the MSC is a relatively small

component. But, again, you then, do you not, find --
you resort to the long-term analysis in order to say,
well, even though it is a small cost, it will have to be
recovered one way or another in due course?
A. Yes.
Q. Now, what I do not see in this analysis is what the
Commission has described as the proportion of the firm's
costs affected by the overcharge, but you accepted that
was a relevant factor that the Commission had said?
A. I think one has to distinguish between the short-run and
the long-run here. So in terms of, you know, the
magnitude of the cost or the magnitude of the cost
change, I am saying that is relevant in the short-run
but it is not relevant in the long-run.
Q. So why did the Commission guidance not have a public
health warning at the bottom saying, "By the way, this
factor we say is important is not important, because you
should be concentrating on the long-run"?
A. Well, I did not write the Commission's guidance so
I cannot comment on that.
Q. So that is wrong, it?
A. Well, I would say that if the Commission's guidance is
implying that these factors are equally important in the
short-run and the long-run, then I would say that that
is incorrect, that some of these factors are more

important in the short-run and less important in the long-run.

Q. When this Tribunal in the *Trucks* case thought that the relative size of the overcharge, by comparison with either revenue or costs of the firm, was a relevant factor, you are saying that this Tribunal was wrong as well, are you?

A. I am saying that, yes, I disagree with that.

Q. Can we move on to look at those factors in somewhat more detail. I am now going to deal with your first one, the intensity of competition.

PROFESSOR WATERSON: Could I just come back on one of those, and apologies if you were coming on to this later.

MR BEAL: Of course.

PROFESSOR WATERSON: But when we think about the size of the cost change, as the Guidelines say, the MSC is a relatively small component, but also companies, merchants, may have an incentive to move people from one payment method to another, so that if you -- I am just making this up, I am not giving away any secrets, but Three, for example, may find that its customers who buy just a month's worth of service, and they do have prices for one month, would probably pay by a card, whereas people who buy a year's worth contract would be moved on to a direct debit.

Similarly, another company, and I cannot remember its name but I should not quote it anyway, said, well, in the payment boxes we organise the payment boxes such that the ones that are cheaper for us are earlier in the list.

So the fact that it is a small cost, nevertheless companies may have some discretion in the proportion of people who actually pay this cost amongst their customers?

A. I mean, that sounds sensible to me. I am sure they would, if they could, they might want to influence the payment methods that people use in order to get them to use whichever is most advantageous for the merchant. I mean, it might -- I am not quite sure how much influence they can, though, and obviously they have to consider what implications that has for the attractiveness of their product in the market.

MR BEAL: If I can just ask a follow-up on that. Of course when we are dealing with pass-on, those who have been channelled into a different form of payment are not the ones we are worried about, are we, because they are not going to be the ones who are, by definition, paying the MIF?

A. Well, I am not sure that -- if I understand your question correctly, I do not think that is right.

So we have a situation where surcharging -- I mean, Mr Cook sort of asked me about this, but surcharging is rather limited. Let us say we can agree on that. So in a situation where you do not have surcharging, then pass-on applies to all customers irrespective of the payment method they are using.

Q. If 90% of your customers are paying -- well, let me recalibrate that question.

If 70% of your customers are paying by direct debit, then for that cohort of customers there is not going to be any question of the MIF being passed on to them, is there, because they are not paying by card?

A. But -- well, what you are saying would only be correct if there is surcharging. If there is no surcharging -- if everybody is paying the same price and the MIF is then passed on into prices, then everybody is paying that higher price irrespective of whether they are paying by a direct debit or card.

Q. Okay. Can we move on to intensity of competition. What I would like to discuss with you is the theory of perfect competition at a microeconomic level, and you would accept, would you not, that firms will set price equal to the short-run marginal cost?

A. Yes.

Q. It will only be in the unrealistic conditions of perfect

competition that you would expect 100% pass-on?
A. Well, I would not say it is only in the unrealistic situation of perfect competition. I would say imperfect competition, you would expect 100% pass-on, but that does not mean to say that 100% pass-on can only happen if you have perfect competition.
Q. Can we look, please, at {RC-J1.4/53/78}. This is the RBB report, paragraph 152.
It says there:
"The extent of passing-on of industry-wide overcharges in competitive markets depends on the relative elasticities ... Importantly, even under perfectly competitive conditions, full passing-on will arise only if supply is fully elastic, ie the supply curve is horizontal, or if demand is fully inelastic."
So that is implying, is it not, that it is only in those unrealistic conditions for the supply and demand curve that you would expect 100% pass-on?
A. It is saying that in the model of perfect competition it is only if the supply curve is perfectly flat that you would have 100% pass-on, yes.
Q. This particular report recognises, does it not, as a matter of theory, the more differentiated products are, the more -- the less fierce competition will be. We can see that perhaps from page 79 of this report,

paragraph 157 {RC-J1.4/53/79}. It says:

"The distinctive feature of oligopolistic settings is that individual firms ..."

MR TIDSWELL: 157?

MR BEAL: Yes, please:

"The distinctive feature of oligopolistic settings is that individual firms are taken to be aware of the strategic nature of their relationships with rivals and the influence that their actions can have on prices. The nature of these interactions, and the intensity of the competition that results, can vary significantly from one setting to another, and a variety of economic models have been developed ... Economic analysis indicates these differences can have an important bearing ..."

We then see in the box, the last three lines:

"This means that such a market may sustain relatively few firms with Bertrand competition [ie an imperfect one]. However, the more differentiated the products supplied by competing firms, the less intense will be the competition between them, even under Bertrand assumptions."

So it is recognising that outside of the confines of perfect competition, the differentiated nature of the product means that the intensity of competition can be lower, and therefore a degree of market power may be experienced by even a large number of firms in an oligopolistic market?

A. Yes.

Q. Now, if we then look, please, in your thirteenth report at paragraph 2.22, {RC-F/10/31}, you have cited the conclusion of this Tribunal in the *Sainsbury's* case. Do you see that?

A. Yes.

Q. You have implied from this that:

"Given that an efficient firm must - in order to turn a profit - pass its costs (one way or another) on ... or ... go out of business, pass-on might be said to be a [fact] of economic life ..."

Do you see that?

A. Yes.

Q. You did not cite the other context to that decision, did you, which puts it very much in its place; correct?

A. So, well, I am not quite sure what you are referring.

Q. Let us have a look at that decision. It is authorities bundle, please, tab D, page 13 -- sorry, tab 13, D/13, starting, please, at page 263 {AB-D/13/263}.

These are some of the paragraphs that straddle the analysis you are seeking to rely upon. At 464, for example, we see that the CAT concluded that:

"... exactly how Sainsbury's dealt with the costs constituted the ... MIF is unknowable, but that ... Sainsbury's would have passed on to consumers what it would, made whatever cost-savings it could and - to the extent that its draft budget returned a profit ... adjusted its spending ... so as to return the expected profit. This approach, we find, is exactly what one would expect of a complex business ..."

We then see at 466 the submission that was made by Mastercard, economic theory indicating that pass-on should have been between 50 and 100%, and that the Sainsbury's pass-on would have been at the higher end of that scale.

Then at 467 we see the citation, part of which you put into your report. Can you see that?

A. Yes.

Q. Then, please, at page 264, paragraph 468 {AB-D/13/264}, it said:

"... we do not need the sort of extensive submission such as is contained in paragraphs 454 to 573 of Mastercard's written closing submissions to tell us this. It is, with great respect to Mastercard's careful and detailed submissions, blindingly obvious that this must be the case. If Sainsbury's did not seek to recover the inevitable costs of its business from its customers, it would rapidly lose more than it made, and become an ex-business."

We then see, at 469, that if that were the extent of the submission then it would be accepted, and indeed Sainsbury's did not seriously seek to challenge this analysis:

"However, if Mastercard was, by its submissions, seeking to assert that it was possible to link a given cost incurred by Sainsbury's to a specific price charged by Sainsbury's for a product sold by it or to a specific saving, then that is a submission that we have to reject as unarguable."

Indeed, at the bottom of that paragraph they say that sort of proposition to establish a nexus would be a "frankly absurd one".

Now, what I am asking you is why you chose to pick from the middle of that quite detailed section of reasoning a particular series of lines, but not put it in its proper context of the findings that suggested the logical conclusion that might otherwise be drawn was a "frankly absurd one"?

A. Well, I think I was just focusing on the sort of economics bit, rather than the bit that is talking about causation and what I would consider to be more legal issues.

Q. When looking at the intensity of competition, you focused on net margins. That is right, is it not?
A. Yes.
Q. You have done that by reference to some data produced by Professor Damodaran in New York?
A. Yes.
Q. Are you aware that firms typically base pricing decisions on gross margins?
A. Well, I think there is a difference between when one is analysing pricing decisions and when one is analysing the level of competition. So in terms of the level of competition, you would expect that if firms have market power that they would be able to earn a higher net margin than if they do not face competition. So I am using net margins here to analyse the level of competition.
Q. Gross margins you would accept are the difference between revenue and the cost of goods sold?
A. Yes.
Q. The total expenditure is then deducted from the gross profit to give the net profit or the EBITDA figures; correct?
A. Yes.
Q. To the extent that pricing decisions taken by merchants are based on the analysis of the gross margin, rather

than the EBITDA margin, a net margin approach would focus on the wrong bit?

A. Okay, well, I think we are confusing two things or possibly three things here. So, first of all, you are talking about how firms set prices, and you are saying -- you are hypothesising that firms set prices based on gross margins rather than net margins. So I think that raises a question about whether that is always the case, and particularly when one is thinking about the long-run. So it might be that in the short-run firms are focusing on gross margins, but clearly there is an additional element of cost between the gross margin and the net margin which has to be recovered.

Ultimately a firm is going to be concerned with recovering not just its COGS but also its overhead costs, or however you define that additional cost. So I think that is the first sort of question in terms of the assumption in your question.

Q. You have not just been looking at net margins in order to understand whether it is a particularly intense competitive sector, have you? You have also been making comparisons between the size of the MSC and the net margins that firms, in your analysis, obtain over the short to long-run?

A. Sorry, if I can just go back to your previous question. Your previous question was talking about where I am analysing the level of competition. Now, I would say that when you are analysing the level of competition and you are using margins to do that, the appropriate measure to use is net margins.

The point here is that a firm might make high gross margins because it has very high fixed costs, and it needs to make a high gross margin to cover that fixed cost. That could be true in a very competitive market, and it could be that firms have a relatively high gross margin but a relatively low net margin, and it is simply that they need to make sure that they have a gross margin in order to cover those overhead costs.

Q. So are you or are you not suggesting that net margins is what will drive pricing decisions?

A. I am saying that in the long-run it will, yes.

Q. Can we look, please, at {RC-G/3/68}. This is part of Mr Economides' second report, paragraph 2.110.2. This refers to a Which? 2024 study, which found that Aldi and Lidl were two of the cheapest major UK grocers. We then see:

"Aldi has pledged to cut more prices than ever before in 2024 as it reinforces its commitment to never be beaten on price. The UK's lowest-priced supermarket has already invested more than £125 million [and so on]. And it is planning to continue cutting prices across a wide range of products ..."

Can you see that?

A. Yes.

Q. "Aldi had adopted a 'low price' strategy as part of its long-term brand strategy sacrificing immediate profits to drive sales volume and gain market share."

Can you see that?

A. Yes.

Q. As a result of that, its gross margin had declined from circa 6.6% to circa 3.5% over that period. So that is a company that is sacrificing its gross profit in order to gain market share, is it not?

A. Yes.

Q. But that will not tell you anything about whether or not it is in a competitive industry or not. It has chosen to adopt a strategy to gain market share in what would otherwise be a tolerably competitive market?

A. Then its competitors will have to react to that, will they not? If they are losing market share to Aldi, then they will need to react to that, and that is likely to result in a reduction in their net margins as well.

Q. If we then please look at paragraph 2.132 here, which is page 78 {RC-G/3/78}, we see there that:

"... firms are more likely to seek to increase prices when faced ... with a decline in gross profit margins, when circumstances allow, than when faced ... with a decline in operating profit margin for reasons other than a decline in gross profit margins, in other words by an increase in overheads."

So what Mr Economides is there saying is that it will be gross margin that is driving a competitive response to a particular industry rather than a decline in operating profit margin? (Pause)

A. Well, I am not quite sure about the context that Mr Economides is talking about here, because I think what he says may well be true in the short-run, but in the long-run what firms are concerned about is their net profit. I mean, that is what their shareholders are concerned about.

Q. If we can then please look to 2.135.1 at page 81 {RC-G/3/81}, what he there says is:

"Increasing product or service prices, especially in cases where there has been a material increase in key input costs and where competitive circumstances allow the firm to do so."

Would be where, for example, a firm would feel comfortable raising its prices. So, in other words, if the firm sees that it is a key increase in its input

costs which is likely to affect the entire sector, it
will feel it has the headroom to be able to raise its
prices on the back of that?

A. So this -- I am not quite sure I understand the point
Mr Economides is making here. Is he talking about the
fact that if this is an industry-wide cost increase,
then that is more likely to be passed on?

Q. No, what he is saying is if the firm has visibility that
there has been a material increase in a key cost input
which is likely to affect the entire industry, then it
will have the comfort to know that it can raise its
prices accordingly?

A. Yes, so I think that is what I understood he is saying.
He is saying that if this price -- if this cost increase
is industry-wide, or I would -- well, I would say the
actual criteria is whether it is market-wide, is to do
with whether it applies to a firm and its competitors.
In that situation, a firm is more likely to pass on the
cost increase.

Q. I can give you a concrete example, perhaps. Imagine
that there is a cost in the -- a cost increase in the
price of coffee, one would expect to see high street
retailers of lattes, cappuccinos, that one buys in the
morning, raising their prices in order to take into
account that increase in a very key component of the

product they are selling?

A. Because all of the retail businesses that you are describing have all faced that cost increase, and therefore you would expect them all to pass it on, yes?

Q. Whereas Compass Lexicon is not likely to increase your consultancy hourly rate, is it, as a result of an increase of coffee beans for your coffee machines at work?

A. Yes.

Q. Can we then please look at {RC-G/3/86}, paragraph 2.139 in Mr Economides' second report. He says:

"The inability of a business to achieve its targets in terms of operating profit margin (ie gross profit minus overhead costs) may be the result of a decline in gross profit or increase in overhead costs."

Can you see that?

A. Yes.

Q. Then at 2.142, further down that page, he says that changes to the operating profit margin or bottom line may trigger a different response. Can you see that?

So, for example, a firm may decide to cancel planned increases in personnel costs in order to get the overheads figure back down, or, turning over the page, have a pay freeze, or, under 2.142.2, reduce commercial costs or marketing expenditure, it gives some examples of that. Going through to 2.142.3, page 88 {RC-G/3/88}, they might implement a temporary freeze on non-essential business costs, for example, cancelling travel and company events.

So these are all responses that may be driven by a change in the overhead costs ratio; correct?

A. Sorry, can we go back to -- this was a sort of very long, effectively, sentence. Can we go back to the beginning, to see what Mr Economides said at the beginning of this?

Q. That is at page -- it started at 2.142 {RC-G/3/86}. Sorry, 2.139 is the start of it. Then 2.142 further down that page. (Pause)

A. So he seems to be distinguishing between an issue related to overhead costs and underperformance in terms of gross profit.

Q. Well, he is distinguishing two things. He is distinguishing between gross profit margin and operating profit margin. That is the first thing, see paragraph 2.139. You would accept, would you not, that that is a distinction that a business is likely to draw?

A. Yes.

Q. Then he is then saying what can they do about a change in the gross profit margin, and that is the bit we

looked at a moment ago, and he is now saying what can they do about a change in the operating profit margin if it is in fact reflecting a change in overhead costs. What he posits, let me put these to you just as broad abstract propositions and see whether you agree. A firm that recognises that there is an increase in its overhead costs could, for example, pursue a cost avoidance scheme, could it not? It could decide to shelve planned expenditure?
A. Yes.
Q. It could reduce its marketing expenditure?
A. Yes.
Q. It could put a temporary freeze on non-essential business costs?
A. Yes.
Q. It could, in theory, negotiate down prices from external suppliers?
A. Well, that would obviously depend on its negotiating power with its suppliers.
Q. It could review its headcount, so it could let people go?
A. Yes.
Q. It could postpone capital expenditure?
A. Yes. I suppose the point about all of those actions is that they all have consequences. So in the short run --

for example, in the short run a firm might have a hiring freeze, or something like that, but obviously that is going to have long run consequences if it has a hiring freeze. So it might be that it takes these sort of actions in the short-run, but they might not be sustainable in the long-run, and in the long-run it might have to instead take the action to increase its prices in order to recover the increase in its costs.

Q. Could we look, please, at page 91, paragraph 2.145 {RC-G/3/91} of Mr Economides' second report.

What he says there is:

"Although increasing prices in response to an increase in overheads is a course of action that is available, it is in fact not usually the right course of action or one that is adopted by the management teams of firms. In my experience, this is the case because an increase in prices will typically lead to a decrease in volume and consequently, in the vast majority of products where demand is elastic to price changes, of revenue. This in turn may mean that total gross profit of the business may decline in absolute terms ..."

So, in short, what he is recognising there is that if you have seen overheads go up, the right answer may well not be to increase prices, because that might impact on the demand for your products?

A. Well, so this raises the question as to whether this is a market-wide or a firm-specific cost increase, because if it is a firm-specific cost increase, then what Mr Economides says here would apply, in the sense that if you put up your prices, then you are going to lose business to your competitors.

I think the point is that if it is a market-wide cost increase, so that all of the firms in the industry are facing the same cost increase, then you would expect that they would all be able to put up their prices, because they are all facing the same cost increase.

Q. That would require the firm to have identified that it was indeed a market-wide increase in its cost of goods sold, thereby affecting its gross profit margin?

A. Well, it could do, or it could be that they just learn this because they see competitors increasing prices and therefore they react to that.

PROFESSOR WATERSON: Just coming back to this point. Of course if the demand curve facing a particular firm within an industry of -- say, a differentiated product industry, will be much more elastic than the demand curve facing the industry, and your point really about whether it is firm-related or market-related relates to those two different elasticities?

A. Yes.

PROFESSOR WATERSON: But even in the case of the market-wide cost, there will be, in principle, a volume effect?
A. Yes.
MR TIDSWELL: While Mr Beal is interrupted, I am going to have a go as well, if I may.
You have talked before about maximising the net return to shareholders. Is that something different from profit maximisation, which we are talking about here or, is it saying the same thing?
A. It is the same thing, yes.
MR TIDSWELL: That therefore requires a focus on marginal cost, is that right? Effectively, the focus of profit maximisation activity is to look at margin cost?
A. Well, so in the short-run it is, but obviously -- I mean, the point I am making is that in the long-run, what shareholders care about is not the gross margin, they care about the net margin. So if a firm is facing an increase in its overhead costs and it does not react to that in some way, then its net margin will fall, and that will obviously upset its shareholders.
So there is, you know, pressure from shareholders to ensure that firms do something if their overhead costs increase.
MR TIDSWELL: Yes. So you are saying then that in the long run, profit maximisation is not about a marginal cost

focus, it is on something else?

A. Yes.

MR TIDSWELL: But if the -- as I understand it, marginal cost is not something that is easily identified, and so people tend to use cost of goods sold, and normally a large item of cost of goods sold, and a reference to market conditions and demand, as they see it, as, if you like, a sense-check for what the pricing should be, and that would -- they would hope and anticipate that if they get that right, it is going to cover their overhead costs.

So on a regular basis, that exercise is being carried out and no doubt adjusted in lots of different ways, but at the end of the day that is still the exercise that determines how prices are set. There is no other exercise that you are suggesting would happen, are you?

A. Well, I suppose the other -- I mean, what might happen is a firm is acting in that way, but because its overheads have gone up it finds that, you know, acting in that way is leading to a fall in net margin and therefore it has to react to that in some way.

I think this is what Mr Economides is also saying. He is saying, well, firms need to react to the fact that their costs have gone up. I think what Mr Economides is saying is that they react to it by trying to reduce other costs, and I think that -- in my mind, that raises two points. First of all, as I have said, what are the consequences of doing that? Because, you know, these things are not costless. If you have a hiring freeze, or something like that, it has an impact on the business. Secondly, there is the fact that many of these things are things which businesses are generally trying to do anyway. Businesses are always trying to minimise their costs.

So in the long-run, you would expect the firm to be doing these things anyway. It is not really a long-run solution to an increase in overhead costs to do things that you would, if you are a profit-maximising firm, be doing in the long-run anyway.

MR TIDSWELL: There might be a whole lot of things -- I think the point Mr Economides was making, as I understand it, is that there might be a lot of things that happen, some of which may, as you say, not survive the long-run, but some of which you might say, for example, a firm might end up accepting a lower net margin over time, and we have seen some evidence that that is in fact what happens in some market, is it not?

A. Yes, well, a firm can accept a lower net margin. The question is how the shareholders react to that.

MR TIDSWELL: Well, it may be that it is difficult to do anything about that because of the pricing dynamics in the market, but you would say those pricing dynamics should reflect the market-wide cost, and therefore everybody should have the same incentive, is that right?
A. Yes.
MR TIDSWELL: So a difficulty with this really is knowing how you, if you like, draw a line from a small cost increase into some of the things we are talking about, and then how it goes into the price. It is really quite difficult to make that causal connection, is it not?
A. Yes. I mean, I think the only way that I can sort of explain it is the fact that -- I think I may have said this already -- is the fact that these -- you know, everything can be broken down to into a smaller unit. So these small increases in cost accumulate to eventually be a large increase in cost. At some point you reach a tipping point where you have to react to it, and I think the thing to recognise is that when you reach that tipping point, that tipping point is not simply a reaction to the last small increase in price, it is a reaction to all of the cumulative small increases in price that have got you to that tipping point.
MR TIDSWELL: But the reaction could be quite diverse. It

could be any of the things Mr Economides talks about, at least in the short to medium term, and possibly the loss of volume effect, and possibly a decision on margin, and lots of other things, could it not?
A. It could, yes. I suppose the point I would just make is I think that -- well, from my reading of what Mr Economides is talking about, they sound like short-run reactions, which I would question whether they are sustainable in the long-run.
MR TIDSWELL: Thank you.
Mr Beal, sorry if I trespassed on your ...
MR BEAL: Thank you. The point I was about to flesh out, if I may now perhaps try and put it in a slightly different way, but it is a variation on the same theme, if can put it that way, sir.
So we have established, I think, that you recognise that gross profit margin is what will be primarily the focus of attention of a firm at least in the short run. Can we agree on that much?
A. In the short run, yes.
Q. In the short run, the thing that is going to move the gross profit margin most is a change in the cost of goods sold; correct?
A. Yes.
Q. So if you are a financial director of a company and you

see a big shift in the core component of your outward product, you would say: that is a big change, I am going to potentially change my pricing up or down; correct?
A. Yes.
Q. You are not going to be afraid at that point that you are going to have a big impact on demand if it is an industry-wide cost of goods sold change that is likely to affect your competitors in the same way, just as a matter of common sense?
A. Yes.
Q. So if that happens, it is open to a firm, is it not, in the short-run, at that point, to say: I may have got my profit-maximising price in the short-run wrong and therefore I am prepared to look at changing it?
A. Yes.
Q. What we have I think also established is that if overheads are not treated by the firm as being a cost of goods sold, it is not going to feed into that mechanic, is it? It is not going to go into that mechanism?
A. Into that short-run mechanism, no.
Q. So we need to find on your case -- I am saying "case", sorry -- on your analysis, we need to find a different mechanism from the short-run price adjustment mechanism in order to explain how you say that change in the overhead, even though it is very small, even though it

has not hit the consciousness of the firm, is going to be translated into a change of prices downstream; correct?
A. Yes.
Q. Your answer might be, well, over the long-run it will happen -- to paraphrase Blondie -- one way or another; correct?
A. Well, I can maybe be a bit more specific about it than that, which is obviously --
Q. What is your mechanism?
A. Well, I think it is an extension of what we have just been discussing. So, you know, shareholders are concerned about the overall profitability of a firm, they are not just concerned about the gross margin, and --
Q. So they are looking at the EBITDA standard in order to work out return on investment, return on capital invested, etc?
A. Yes. Then that feeds through. So shareholders put pressure on the directors of a business who put pressure on the managers, and so on, then the feeds through ultimately to pressure on whoever is setting prices to make sure that they are setting a price which is maximising the profits of the business and providing the return to shareholders that shareholders are expecting.

Q. But if all that the directors -- if I am the finance director and all I know is that my EBITDA has dropped, but I do not know what has caused the EBITDA to drop, I would be mad, would I not, to change my prices, because I would not know what the volume effect was?
A. Well --
Q. I could think I was doing the right thing by passing on, in this indirect mechanism that you have identified, the perceived cost, but it could lead to a wholesale drop-off in my demand, which means I am far worse off than I would have been if I had just stuck where I was?
A. Well, I suppose you can think of it that a firm has immediately two options, so one is to increase price and the other is to reduce costs, those are the two ways that it can return its profit margin to the original level, and Mr Economides is saying, well, what firms will do is that they will do something to cut costs.
Now, what I am saying is I am saying if a firm is already operating efficiently, then essentially it does have not scope to reduce its costs. Maybe it can do things in the short-run that reduce its costs, but because those have long-run consequences, those are not going to be sustainable.
So the only way that a firm is going to be able to address this by reducing costs is if it is acting in

some way inefficiently in the first place, and in a competitive market you would not expect firms to be doing that; in a competitive market, you would expect that firms are already attempting to minimise their costs. So if the two options are increase price or reduce cost, and reduce cost is not an option, what you are left with is increase price.
Q. But what if the firm does not know whether increasing prices or reducing costs is going to produce a better EBITDA rate?
A. Well, I think businesses may be in a situation where they know that their margin has reduced, they know that they need to do something about it.
Q. Yes, but if they do not know why it has reduced. If, for example, they have visibility of cost of goods sold, because that is the thing they concentrate on, and they know that has not changed, and they know their gross profit margin is the same, and the only thing that has changed is that the EBITDA margin has decreased, then they are going to know that presumably the overheads have increased; correct?
A. Yes.
Q. But they are not going to know whether that overhead increase is a variable, a semi-variable or a fixed overhead, are they, and if they are already thinking:

our cross profit margin is where it should be and we are profit maximising, it is a leap into the dark to say we are going to increase prices regardless, because you do not know what the volume will be?

A. But they may be -- I am saying that ultimately they will be forced to do that because --

Q. Ultimately when? Say we have an annual budgeting cycle, an annual management information cycle. Not quarterly, because that is not going to be long-run enough for you, so let us assume the classic budgetary approach, the annual MI that every firm gets. It is not necessarily -- on your case, on your analysis, it is not going to know, is it, at what point in a particular business cycle the tipping point is reached?

A. Well, it is not a question of knowing when the tipping point is reached, the point is a tipping point is reached. So at some point the business reaches a situation where it has had a reduction in its net margin, and there is pressure from shareholders or pressure from directors or whoever to do something about that, and the firm therefore has to do something.

Q. Imagine that is not in a given accounting year. Do they review their figures from four years ago periodically to make sure that they are still on track?

A. Well, I think firms know what is happening to their overall level of the profits, that is clearly something they know, and they can see if their overall level of profit is falling.

Q. But they are not going to know what has caused the change in the EBITDA, are they, unless they dive into the granularity of the underlying cost stack that you are saying is ex hypothesi causing the change?

A. Well, I think the point is that the firm knows, okay, my gross margin is the same but my net profits have gone down, so therefore that means that my overheads have gone up, and therefore I need to react to that.

Q. I could decrease my prices, faced with that overhead increase, in order to generate more volume, as we saw with Aldi, and that increase in volume would lead to a reduced overhead per unit sold, which would then reduce the overhead per unit sold, which would cure the problem, drive volume gain, drive revenue gain, and deal with the problem of increasing overheads?

A. Firms -- well, economic theory would not suggest that you react to an increase in cost by reducing your price. That is not going to be a profit-maximising strategy.

Q. Of course it would, if it produces greater volume by decreasing the price and you gain market share from someone else.

A. Yes, but you have reduced the margin that you make on every sale, so that is not going to be a profit-maximising response.

Q. Of course it is, because you are spreading -- the thing you have identified as being the cost increase is not the marginal cost, it is the overhead cost, and you are spreading that overhead cost amongst a greater quantity of volume sold. So you are reducing the per unit overhead cost, and that leads to greater margin. So you rescue the EBITDA margin by spreading the cost over a greater volume?

A. Well, you are assuming there that this increase in overheads is a fixed cost.

Q. Well, if you do not know what it is, the point is you do not know whether or not it is going to be a variable cost, a fixed cost or a semi-variable cost, you are simply trying to deal with the problem before you. What I am putting to you is that a simple change in the EBITDA margin is not, as a matter of profit-maximising behaviour, going to lead inevitably to an increase in costs, is it?

A. Well, I think it is --

Q. Sorry, an increase in prices?

A. Well, in my opinion as an economist, I think it is very unlikely that a firm would react to that situation by cutting its prices. I think it will react to that situation either by increasing its prices or cutting its costs and, as I said, I think in the long-run, cutting -- if the firm is operating in a competitive market, it is unlikely to have scope in the long-run to cut it costs further, so the only option is to increase its price.

PROFESSOR WATERSON: Can I just come in on this? So another mechanism that one might identify, and we have seen this in mid-market restaurant chains a great deal, is they think, well, we have a range of outlets across the country, some are very profitable, others are not very profitable, we are facing this problem that, you know, we are not earning what shareholders expect, maybe we should shrink the chain. That may have some cost implications, but it may enable them to reduce their overhead costs to such an extent that they are able to make more money.

A. Yes, I can see that might be a possibility, yes, if they have a situation where there are different levels of cost of different outlets. But, again, this is something which businesses might be doing anyway, reviewing: which are our least efficient outlets, and doing something about it, which might be trying to make them more efficient, or deciding there is nothing that can be done to make it more efficient, so we will close

down that outlet.
MR BEAL: Could we look, please --
THE CHAIRMAN: Can I ask you, the questions that you are putting to Mr Coombs were based on the fact that firms would not know where the increase in overheads has come from, is that right?
MR BEAL: Well, it was based on an increase in overheads being incapable of being broken down in a meaningful way between fixed overheads, semi-variable overheads and variable overheads, because in this case the -- you to you not have the visibility of the specific rise in overheads being attributable to an increase in the MSC, so that is the factual premise I am trying to get to.
THE CHAIRMAN: Right. In reality, if you are looking at -- if a firm is looking at its overheads, and knows that in some way or other overheads have gone up, presumably it will be able to work out in what respect those overheads have gone up?
MR BEAL: So the firm will have -- well, it is not for me to give evidence. I will have to swear myself in and be cross-examined by all sorts of people.
Let me put this perhaps to the witness: a firm's accountancy software, and we have seen plenty of examples of where the analysed claimants in this case put MSCs, with the exception arguably of one or two,

none of them identify a line item in their accounting software saying this is MSCs, do they?

A. That may well be the case. I cannot say that I have looked at that evidence in detail.

Q. If a company such as that, and it is broadly reflective of some pretty large companies in this economy, if that is the approach of a company like that, then the position would be that they simply do not know what has triggered an increase in the overall overhead stack, beyond it is broken down by reference to certain standard categories of overhead expenses?

A. Yes. I mean, I am sure -- I would agree with the Chairman that I am sure a company in that situation would want to investigate the cause of the increase in overheads and try and identify, you know, what has gone up. But you may well be right that when they do that, the category that they identify might be a category which is broader than just the MSC. So the MSC is a component of that category.

Q. There would be some market-wide increases in overheads that are likely to be highly visible. For example, an increase in commercial rents tied in with an inflation index, as we have seen in the last two to three years. People are paying more money on their rents because of an inflation-based index to commercial rent pricing, for

example?
A. Sorry, I did not quite catch what the question was there.
Q. The question is: I am giving you an example of a market-wide overhead increase which is visible and can be reported in the accounts and which somebody can do something about.
A. Yes, I am sure that is true.
Q. What I am suggesting to you is that we do not have the same visibility for a very small cost like the MSC?
A. No, but you might -- so if the MSC is part of a category, you might be -- you might -- well, you would identify that that category has gone up, and then you might investigate within that category what is causing that category to go up.
Q. Yes. So the mechanism, as I understand it, you are identifying is the finance team sit down, they look at the management information, they look at the annual accounts, they look at the quarterly reports, and they see that costs as a subset have increased, and they can respond to it by either trying to do the cost reduction exercise we have talked about or potentially by increasing prices as a response. Is that what your case is -- your analysis?
A. That is what my opinion is, yes.

Q. That opinion necessarily depends, therefore, on the mechanism being the finance team sitting down with their budgetary information and producing a cross-firm response to the totality of the budgetary information, be that price increases or cost reductions?

A. Yes. I think what I am saying is I am saying that the firm will recognise that there has been an increase in overhead costs and that they will react to that.

Now, it may be that, you know, the exact processes in different firms may vary from firm to firm. I am not trying to sort of speculate about what the exact process is, I am just saying that these will be the incentives on the firm and the incentives on managers within the firm.

Q. For a very small cost, for example the MIF change, if there is a MIF change, a firm might simply decide to absorb a very small cost that it has no visibility about, rather than doing something conscious about it?

A. Well, what I am saying is that I am saying that these small cost increases accumulate so that you might not react to the MIF at the time that it is actually incurred, but you will react to the MIF when you reach the tipping point and therefore you react to the accumulation of cost increases.

Q. Therefore, the trigger for that change in behaviour, be

it price increase, price decrease, cost reduction, whatever, the trigger for that is necessarily going to be a combination of different factors; correct?
A. Yes.
Q. So you are not able to attribute that specific response to that change of factors to the change in the MIF at any stage, are you?
A. No, but I am saying that that does not affect the economic analysis. It does not affect the fact that the firm suffers an increase in cost and reacts to it and that that reaction has been caused by the increase in the MIF. So I am saying it is not caused solely by the increase in the MIF; it is caused by the accumulation of these cost increases but one of the causes is the increase in the MIF.
Q. You would accept that 0.26% of total cost is a very small cost; correct?
A. Yes.
Q. You have seen --
A. Well, sorry, you said 0-point?
Q. 26.
A. Well, it is small but it depends what you compare it with. So it is small --
Q. Total costs is the comparison.
A. So it is a small proportion of cost but it might be

a material proportion of the firm's margin, if a firm --
Q. Let us think about that. 0.26 as a -- you are talking about net margin, not gross margin?
A. Net margin.
Q. Alright. So you would accept that gross margins will be higher?
A. Yes.
Q. So the 0.26% is going to be a relatively small percentage, is it not, even on your analysis, your opinion, of the gross profit margin that a firm earns?
A. It will -- well, obviously it depends on the exact numbers.
Q. Just as a mathematical equation.
A. It is going to be a smaller proportion of the gross margin than of the net margin, yes.
Q. If we are looking at net margins of between 5 and 10%, for the sake of argument, 0.26%, even on that proxy, is still a relatively small amount, is it not?
A. It is, but the evidence that I looked at suggests that retail net margins are more in the region of 3% -- I think 3.2% was the average that I found in the data, so if the average net margin is 3.2%, then 0.26, that is nearly a tenth.
Q. What percentage of that margin is going to be reflected by the cost of goods sold? So doing the maths but

instead of using the MIF proxy, 0.26%, or the MSC charge, 0.26% of total costs, let us look at the proportion of cost of goods sold to total costs and then see how that pans out with the net margin analysis. How does that work?

A. I am not quite sure I follow the question, but what you are saying is that the cost of goods sold will be much larger than the net margin.

Q. Correct.

A. Yes, that is correct, but I think that is a different question from the question you were asking a moment ago, which is that whether 0.26 is small compared to the net margin of the firm and I am saying, well, I do not think it necessarily is small compared to the met margin of the firm.

Q. But it is significantly smaller than the proportion of cost of goods sold which is going to exceed the net margin by a considerable factor, is it not?

A. Yes. So I think maybe what we can agree on is that it is small proportion of the cost of goods sold, yes.

Q. So if you are selecting a proxy that is cost of goods sold, you are necessarily choosing a much more visible and significant and material cost for the firm than the MSC itself?

A. Yes, but I think this is in danger of being a bit circular because we have agreed in this case, I think, some time ago -- well, at least some of us agreed; I think all of the experts currently active in this case have agreed -- that it is not possible to directly estimate the impact on the MSC because of the signal to noise ratio. So one has to look at a proxy and sort of, by definition, that proxy has to be much larger otherwise there is no point using a proxy. You end up with the same problem that you will get if you are analysing the MSC.

Q. Could we look please in your thirteenth report at page 46 {RC-F/10/46}, paragraph 2.58b. You are referring here to the curvature of the demand function. Can you see that, the curvature of the demand curve? You are explaining concave versus convex demand.

A. Yes.

Q. Now, all firms will face a demand curve that reflects less and less demand in the face of increasing prices, will they not?

A. Yes.

Q. All demand curves therefore have a downward sloping curve consistent with the principle of diminishing marginal utility?

A. Yes.

Q. That applies whether the demand curve is convex, concave or linear?

A. Yes.

Q. As I understand it, the point you are making at page 47 of your report, paragraph 2.59 {RC-F/10/47}, is that the more elastic the demand, the less easy it would be for pass-on to take place. Is that right?

A. Yes.

Q. Conversely, the more inelastic the demand, the easier it will be for pass-on to take place?

A. Yes.

Q. Could we then please look at {RC-J1.4/19/36}. This is part of the Commission Guidelines. You will see at the top of the page there -- sorry, bottom of the page there, three different curves and they represent the linear, concave, convex; correct?

A. Yes.

Q. Scrolling up, please, to 171, recital 171, the Commission says that:

"When the demand curve is linear, it has no curvature and the slope is constant. In the case of convex demand, the demand becomes less sensitive to price changes as the price increases. This may be the case if the products or services affected by the overcharge are characterised as essential goods."

Can you see that?

A. Yes.
Q. Now, it is right, is it not, that most of the products that we have been looking at for my clients during this trial would not be categorised as essential goods?
A. So I think your clients are -- I was going to say disproportionately; maybe I do not need to say disproportionately. I think a very large proportion of your clients are in the restaurants and the hotel sector, is that correct?
Q. Certainly the hotel sector is, I think, the biggest chunk of our claimant base --
A. Yes.
Q. -- for example.
A. Yes. So I think you will probably argue that the hotels maybe are not an essential good, yes.
MR BEAL: You then move on to supply curves but I think perhaps that is a natural break.
THE CHAIRMAN: Yes, certainly.
MR BEAL: In terms of progress, I am making reasonable progress but I will prune overnight to ensure that we can give Visa their allotted due tomorrow afternoon and re-examination.

Housekeeping

THE CHAIRMAN: Ms Tolaney, you have something to tell me.
MS TOLANEY: I do. I think, sir, you may have seen a letter

over the short adjournment. We obviously wanted to inform the Tribunal as soon as possible that Mr Merricks and Mastercard have agreed, subject to the approval of the Tribunal, pursuant to Rule 94 of the CAT Rules, a settlement of the Merricks collective proceedings. Obviously in circumstances, as we said in the letter, where in collective proceedings the settlement only comes into effect if approved by the Tribunal, the parties intend to continue their participation in Trial 2 pending such approval.

THE CHAIRMAN: Yes. Well, that was welcome news and congratulations to all concerned in reaching that settlement. As you say, it is obviously subject to approval. You want that hearing to take place as soon as possible?

MS TOLANEY: We do, yes.

THE CHAIRMAN: I do not know how possible that is going to be.

MS TOLANEY: No.

THE CHAIRMAN: But we carry on then, do we --

MS TOLANEY: Indeed.

THE CHAIRMAN: -- in the meantime, slightly oddly, but there we go.

Does that affect the timetable at all? Maybe not.

MS TOLANEY: We do not believe it will affect the timetable,

given where we are now.
THE CHAIRMAN: Okay. Alright. Well, thank you very much.
MS TOLANEY: Thank you.
THE CHAIRMAN: Did you want to say something, Ms Boyd?
MS BOYD: No.
THE CHAIRMAN: Okay. 10.30 tomorrow. Thank you.
(4.32 pm)
(The hearing concluded until 10.30 am
on Wednesday, 4 December 2024)