**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

Ben Lask KC and Thomas Sebastian on Behalf of Allianz (Instructed by Pinsent Masons)

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)

Wednesday, 4 December 2024

(10.30 am)

MR JUSTIN COOMBS (continued)

Cross-examination by MR BEAL (continued)

THE CHAIRMAN: Good morning.

THE WITNESS: Good morning.

MR BEAL: Mr Coombs, I left you on the edge of your seat on the topic of supply curves, and that is where I would like to go now, please.

You have suggested that supply curves in a competitive industry are likely flat. Do you recall that?

A. Well, I am saying -- I would not say that supply curves in a competitive industry are necessarily flat. I would say that supply curves are not always steeply upward sloping. Sometimes they will be flat, and that generally speaking in the long-run they will be flatter than they are in the short-run.

Q. So there is no a priori reason, is there, why the marginal costs of an input, even in a competitive retail sector, would not increase as the quantity supplied increased because of, for example, scarcity issues?

A. Yes. You would normally expect a supply curve to be upward sloping. The point I am just making is about the distinction between the short-run and the long-run.

Q. Obviously some firms are more efficient than others, which may also mean that an upward sloping supply curve makes sense?
A. Yes. So that is the point that Dr Trento makes about there being a merit curve. So you have some firms are relatively higher cost and charge higher prices, and some are relatively lower cost and charge lower prices, so you can think about rank order of these firms from the lowest cost to the highest cost, from the lowest price to the highest price. Then if you are a merchant purchasing from these firms, you would ideally purchase from the cheapest firm, and then you gradually move up the curve to the higher cost.
Q. I thought you said America, but I think you said merit order, as in the electricity industry?
A. Yes.
Q. There are three main factors, are there not, that determine the magnitude of pass-on via prices. Firstly, we have the shape of the supply curve in the counterfactual without the MIF overcharge; correct?
A. Yes.
Q. Secondly, we have how the MIF overcharge affects the counterfactual supply curve and therefore the prices and volumes of sales by a merchant?
A. Yes.

Q. Thirdly, you then have the interaction with the demand curve which determines the price change and the associated volume effect?
A. Yes.
Q. Now, on the first issue, the shape of the supply curve, you have accepted it can be upward sloping and generally is upward sloping?
A. Yes.
Q. In terms of how the MIF overcharge affects the counterfactual supply curve, it is right, is it not, that if it is an industry-wide change in marginal cost, which we obviously dispute, but I will come back to, but if that is right, then the impact would be on an upward shift of the supply curve rather than a move along the supply curve?
A. Yes.
Q. Therefore, even if the supply curve is relatively flat, an upward shift in the entire curve could still have a dramatic effect on the quantity demanded, and therefore price and volume effect?
A. Yes. Well, it depends on the slope of the supply curve and the demand curve, yes.
Q. Now, to the extent that you have implied in your thirteenth report that the impact on the supply curve can be assumed to be insignificant, that really would

not be a fair representation of the evidence you have given, would it?

A. What I am saying is it depends on the slope of the supply curve and, as I was saying, I would expect in the long-run, the supply curve to be flatter than it is in the short-run.

Q. In the real world, you have not carried out any detailed investigation into the shape of the supply curve for this case?

A. No.

Q. Can I then move onto the industry-wide argument, please. Could we look in your thirteenth report, paragraph 2.71 {RC-F/10/49}. If you could cast an eye over 2.71 to 2.73, you are here talking about a situation where a merchant weighs up the benefit of accepting cards and the cost of doing so to see whether or not it is worth the candle of taking cards as a payment method; correct?

A. Yes.

Q. Now, that may have significance perhaps in the early part of the claim period, 1992 or so, but it is a fair point now, is it not, that all of the SSH Claimants are, by definition, large companies that have accepted cards for a material period of time?

A. Well, that may well be true. To be honest, I have not looked in detail at who they are and when they started

accepting cards, but I do not have any reason to dispute what you say.
Q. We have substantial claims for the MIF overcharge, which implies they have paid a substantial quantity of MIF over a lengthy period?
A. Yes. So you are saying that they would not be making a claim unless they had been accepting cards and --
Q. Suffering --
A. -- therefore had suffered a significant loss. Yes, that makes sense.
Q. So as a matter of revealed preference, they have obviously chosen to accept cards as a method of payment?
A. Yes.
Q. Now, I think you were not present -- to your advantage, no doubt -- during Trial 1, but some of the evidence that was given in Trial 1 from the SSH Claimants was to the effect that they had no choice but to take cards. The expression that was used were that Mastercard and Visa cards were "must take cards", and one of the reasons Mr Dryden gave for that was because of a concern about losing business to competitors, which was referred to as the "business stealing effect". Are you familiar with the business stealing effect?
A. Yes.
Q. So it is right, is it not, that certainly in the modern

world, say in the last 15 years, these large businesses have, in practice, had no choice but to take Mastercard and Visa cards?

A. Yes. Well, maybe I would not put it quite that way, but I think this is exactly the point that I have also been making, which is that in a market where most merchants are accepting cards, if you are one of the few merchants who do not accept cards, then you are going to be at a material disadvantage, and therefore most likely you will end up feeling that you will be forced to accept cards, so I think that is the same point that you are making.

Q. But it does not follow, does it, that a card -- a merchant that chooses to accept cards has the freedom to raise its prices as a result? It might simply have to take the hit on its margin in order to grow market share or to maintain its competitive position?

A. Well, I think the point is that it is choosing to accept cards in order to remove the competitive disadvantage that it was previously suffering, where customers would be less likely to go to that merchant because they would prefer to go to one of the competitors that do accept cards.

Q. Now, in terms of whether the MIF is an industry-wide overcharge, you must also accept, must you not, that

whilst I have been talking about my clients, the large end of the spectrum, there is a large proportion of small and medium-sized businesses who do not accept cards?
A. Yes, there are -- well, I think there may be two points to make here. One is that it depends on the market that we are looking at, you know, what is the relevant market. So, you know, one might -- well, I am not quite sure if this is still the case, but at some point in the past it was maybe the case that large supermarkets accepted credit cards and small convenience stores did not. But then the question would be, well, are these firms competing in the same market? Is it that supermarkets and convenience stores are competing directly against each other, or is it for the supermarket their closest competitor is another supermarket, and for the convenience store their closest competitor is another convenience store.
Q. You are looking at the UK-wide economy, are you not?
A. Ultimately, yes.
Q. Could we have a look at Ms Webster's lesser impugned graph at {RC-F/14/124}. This deals with merchants' acceptance of cards by reference to outlet share. We can see there, there is a cut-off for a data point, but ignoring that, even by 2021 there is some 40% of

registered businesses in the UK by number who are not accepting cards?

A. Yes.

Q. Some of those businesses must be exercising a form of competitive constraint even on larger businesses; correct?

A. Well, you say some form of competitive constraint. I suppose the point is that is even if -- even if you look at a particular market, you would say that, well, the firms that are within that market are the closest competitors to each other. That does not mean to say that there is no competition or no substitution to firms outside of that market, but obviously the firms outside of that market are providing a much weaker competitive constraint and less competition on the firms that are in the market.

So going back to my supermarkets example, you might say the supermarkets are competing aggressively with each other. At the margin they might face some competition from the convenience stores, but that is not the main source of competition. The main source of competition is other supermarkets.

Q. As an answer as a matter of principle, I do not think I have any objection to that, but of course your sectorisation approach requires you to lump together very different markets in the same business sector and produce a sectoral result for every business in that sector, does it not?

A. Yes. Maybe I am getting confused as to what we are talking about here.

Q. We are talking about industry-wide cost charges.

A. Yes. Well, so industry wide cost charges are relevant here when one is thinking about a pass-on rate. So we would generally expect -- as I think has previously been discussed, an industry-wide cost you would expect to be passed on at a higher rate than a firm-specific cost.

Now, when we say industry-wide, actually industry-wide is the wrong term to use here. What we should really be talking about is a market-wide cost increase, because the argument here is that what matters is whether competitors face the same cost increase.

So a market-wide cost increase is likely to be passed on at a higher rate than a firm-specific cost increase, but what is relevant here is the market in which the firms compete.

Q. What is your market in sector 11, other retail?

A. So other retail is a collection of lots of different markets. The sector -- just to be clear --

Q. (Overspeaking) -- a mismatch between, then, between your sectoral definition, which drives the pass-on rate for that sector, and your far more refined market analysis, do you not?

A. Yes, indeed. Exactly right. I think -- sorry, I thought this was clear.

So the reason I have chosen these sectors, they are not meant to represent individual markets. That was not how they were derived. The sectors were derived because they are derived from a data source from the Card Association which then provides data on card volumes for these different sectors, and then those are the weights that I then use to create a weighted average of the pass-on rates for these different sectors.

The pass-on rates that I calculate for these sectors are obviously an average pass-on rate across lots of different markets. The point is that ultimately what I am trying to calculate is an average across the whole UK economy, and in order to get there I calculate average pass-on rates across these sectors. These sectors are not meant to represent individual markets.

Q. So let us take it down to the market level of the analysis, rather than sectoral analysis. Even within a given market, let us define it perhaps as supermarkets, that is one you have referred to, you are not suggesting that all supermarkets pay 0.2% on all their sales to Visa or Mastercard, are you?

A. I am saying that I would expect that all supermarkets are likely to be accepting credit cards. If most supermarkets accept credits cards and you are the one supermarket that does not, then you will be at a significant disadvantage, so it is quite likely that all, or nearly all, supermarkets would therefore accept credit cards in that situation because their competitors do.
Q. But there are different rates for debit and credit card usage; correct?
A. Yes.
Q. There are different rates for consumer versus commercial card usage?
A. Yes. Well, that is a different point. So one point is about whether they all accept credit cards, the other question is whether they are all paying the same level of the MSC. As to whether they all pay the same level of the MSC, that is not something I have looked at, but it may well be the case that they pay different levels of MSC.
Q. There are different rates of card present, card not present, inter-regional and so on?
A. Possibly, yes.
Q. There are obviously different costs associated with acceptance of cards versus acceptance of cash?

A. Possibly, yes.

Q. So it cannot be right, can it, that the MIF overcharge will have the same impact for all businesses in a given market, let alone a sector?

A. Well, that is -- that depends on the facts, does it not, which I do not know.

Q. So in reality, the specific composition of the MIFs and the MSCs charged to a given cohort can vary greatly, can it not?

A. Well, in theory, it can vary. As I say, I do not know how much it actually varies in practice between the same firms in the same market.

Q. Can we have a look at Mr Murgatroyd's first report, please {RC-F/6/19}, paragraph 86. Did I say page 86? I meant page 19 and paragraph 86. It should be Figure 1.

So the lead-in is in paragraph 86, where Mr Murgatroyd says:

"Figure 1 similarly shows a decrease in the MIF rate paid by ABSL immediately following the introduction of the IFR."

Can we then scroll down to Figure 1 on the next page {RC-F/6/20}. What we see there, amongst ... still fuzzy, is two or three different entities within the Allianz group of companies who are all -- each of them is paying different MIF rates, even though they are within the same corporate group. Can you see that?

A. Yes.

Q. You can see a big spike in the MIF rate paid by one of them after the introduction of -- after Brexit in the light of changes to intra-EAA -- intra-EEA MIF rates became inter-regional, and inter-regional rates went up for card not present transactions; correct?

A. Yes.

Q. Could we then please go to page 24 of this report {RC-F/6/24}, paragraph 105, where Mr Murgatroyd introduces Figure 2.

I think, to get the context of Figure 2, the bottom of 105 and 106 {RC-F/6/23}. 106:

"... Figure 2 below presents the transaction value of payments made by card as a percentage of total [gross written premiums], for each of [the Allianz entities] ..."

Then can we turn over the page, please, to Figure 2 {RC-F/6/24}. Figure 2 there notes the different payment methods for the type of insurance on offer means that the MIF does not affect those industry participants in the same way, does it?

A. No, it does not, but the question that this raises is: what is the -- so these are subsidiaries of Allianz selling insurance products, and it may well be that the mix of insurance products that they are selling is different. I do not know, to be honest, whether that is the case or not.

So what you would want to do is a like for like comparison of insurance products which are sold, you know, by firms that have the same mix of business in order to make a like-for-like comparison.

Q. Well, what this shows, does it not, is that where you have a cohort of customers who are more likely to be paying by direct debit, because, for example, they are paying their annual household insurance cover, that will have a different impact -- the MSC will have a different impact depending on the card usage acceptance rates, even within two subsidiaries of the same firm?

A. Yes.

Q. The same would also hold true, would it not, of purely online retailers who have no choice but to accept a form of electronic payment method, principally cards, versus brick and mortar retailers?

A. So you are saying that there will be a difference between the online and the bricks and mortar retailers?

Q. Yes.

A. Yes.

Q. In terms of overhead costs, some overhead costs will be

industry-wide, will they not, such as the need to maintain liability insurance?
A. Yes.
Q. Or, for example, the average commercial rent payable for premises?
A. Well, that might be -- that might vary between different firms.
Q. So the fact that a particular cost may be one that is commonly incurred does not help you determine, does it, whether or not a proxy based on COGS, overheads or total costs is the most appropriate proxy?
A. Sorry, I did not quite follow the question. You are saying that if ...
Q. The question is given that some overhead can be fixed, some are variable, and given that we have seen, even within a card acceptance level, there is variable acceptance and therefore a variable impact of the MSC on firms, even if you are suggesting it is an industry-wide cost, the reality is none of this analysis helps us determine whether COGS, overheads or total costs is the most appropriate proxy?
A. You are saying that because you do not know to what extent it represents an industry-wide cost rather than a firm-specific cost?
Q. Well, if it has a differential impact even within the

same market, and even within the same sector, a fortiori within the same sector, then the fact that it is not an industry-wide cost in that sense means it is going to be -- necessarily the treatment of the MSC will be differential as well?
A. Yes. Well, I think -- I may be missing the point here, but I think this is the point that I made previously, that when we are looking at data from individual merchants there will be a mixture of market-wide and firm-specific cost changes that are being captured there.
Q. Can I come on, please, to look at your ad valorem versus per unit point. Now, you are aware, aren't you, since the IFR came into force, there has been a general process of unbundling MIF charges from the MSC?
A. Yes.
Q. You are presumably aware that the majority of large claimants have increasingly been on IC+ or IC++ contracts, certainly since the introduction of the IFR?
A. Yes.
Q. Most large businesses therefore are on ad valorem rates because the IFR caps given for consumer card, and in the light of the commitments, are the ones that are routinely charged; correct?
A. Yes.

Q. Other things being equal, I think you accept that an ad valorem cost increase is passed on to a lower extent than a per unit cost increase; correct?
A. Well, it depends on the level of competition in the market and the level of margins. So that is true in markets where there is less competition and higher margins. It becomes less true in markets where there is more competition and lower margins.
Q. Can we look in your thirteenth report, please {RC-F/10/54}, paragraph 2.93. You there say:

"Economic theory predicts that, in market with imperfect competition, pass-on rates of per-unit cost changes are typically greater than pass-on rates of ad valorem cost changes."

I thought we had established yesterday that the conditions of perfect competition were a theoretical construct and that, for better or worse, we are dealing with a position of imperfect competition, but with differing levels of intensity in the level of that competition?
A. Yes, and I am saying that the intensity of competition affects the extent to which there is a difference between an ad valorem and a per unit charge. The more competitive the industry, the less important this distinction becomes.

Q. Because MSCs are ad valorem, you have sought to compare them with VAT and other tax changes, is that right?
A. Yes.
Q. Now, VAT is a classic case, is it not, where you would expect to be billed for VAT if you are a customer receiving a good or service from a VAT-registered company?
A. Yes.
Q. So you know you will have to pay the VAT on top, do you not?
A. Yes.
Q. Indeed, you are aware that there is a statutory obligation on VAT-registered companies to charge expressly for VAT in an invoice?
A. I was not aware of that, but I will accept that it is true.
Q. Well, subject to certain small exemptions for low level costs on a monthly basis, etc, but I will not bore you with the detail of that.
So it is routine, is it not, to find that a charge to VAT is passed on in full to the customer because it is the structure of the tax?
A. Well, the fact that it is the structure of a tax does not determine the -- I am not quite sure what you mean by the structure of the tax there, actually.

Q. Well, if someone charges -- a builder comes to your house and says, "I am going to charge you £2,000 for the renovation work that I am going to carry out to your property", and you say, "Is that £2,000 with VAT?", and the builder says, "Yes", you know you will get an invoice at the end that is £2,000 plus £400 for VAT on top?
A. You will, yes.
Q. So you know that you are going to be on the hook for the VAT sum on top of whatever price you agree net of VAT?
A. Yes.
Q. The business itself does not treat the VAT as a cost that goes into its P&L, does it? Profit and loss account?
A. No.
Q. No sensible business would include the VAT that it has to account for to the Revenue in its -- HMRC; it would not include that in its revenue top line, would it, in its accounts? It would not say, "and we have earned revenue that is attributable to VAT that we will nonetheless be paying to HMRC"?
A. Well, when I have -- the data that I received from the merchants, it sets out generally their revenues and it sets out the VAT that they have received as well. So it is --

Q. You mean the VAT they have paid or the VAT they have received?
A. Well, I think it sets out both. So the VAT is in the accounts. I think your -- I am not quite sure what point you are making. Is the point you are making that when they are reporting the turnover of the business in statutory accounts, that that turnover will not include the VAT, is that the point you are making?
Q. That is one of the points. But it will not be in the management information either, will it, because it is a separate accounting obligation. It gets treated as a statutory obligation, it does not get treated as either revenue or as an account in management information -- sorry, as revenue or as a cost?
A. I suppose that is up to the business. But you are probably right, that probably is what most businesses do, yes.
Q. Well, you have relied quite heavily on the EBITDA margin, and of course that is profitability before tax by definition?
A. Yes.
Q. Tax would include VAT?
A. Yes.
Q. Could we look, please, at one of the studies that you have cited in your thirteenth report. That is

Benedek et al {RC-J6/29/2}. This deals with VAT pass-on and it suggests, does it not, in the first paragraph:

"It is almost universally assumed in practical policy making ... indirect tax changes are fully and exactly passed through to consumer prices ..."

Then they refer to some studies that have been carried out.

In the second paragraph, they say:

"The extent and timing of VAT pass-through thus becomes an empirical issue. The last few years have seen [various] analysis ..."

It then says in the third paragraph:

Many of the most careful studies ... focus on the effects of changes in the tax treatment of a narrow set of items ..."

Then it explains what it is doing there.

Then the fourth paragraph:

"The aim of this paper is to cast new light on this and other fundamental issues ..."

Then they explain what methodology they have adopted. Can you see that?

A. Yes.

Q. If we then please look at page 12 {RC-J6/29/12}, the conclusion that the authors reached. Just above "Pass through by type of VAT ...", can you see a paragraph that says:

"Two aspects of these results stand out. First, the total pass-through is statistically different from unity ... at 99% confidence. The null of full pass-through ... is firmly rejected ... Simply assuming full pass-through of all VAT reforms is ... a significant mistake. Second, only contemporaneous effects in the month of implementation matter: effects before or after ... are negligible and insignificant."

So what this is suggesting, on the basis of the statistical analysis that the authors have carried out, is that VAT in fact gets passed through, contrary to everyone's perception, at a lower sum than 100%; correct?

A. That is what this paper concludes, yes.

Q. Secondly, the effect of that pass-through is felt contemporaneously with the implementation of the change?

A. Yes.

Q. If we then, please, look at page 14 {RC-J6/29/14}, we there see, halfway down the page, there is a paragraph that begins, "Changes ...", can you see that?

A. Yes.

Q. "Changes in reduced VAT rate show a very different pattern of pass through ... The contemporaneous price effect is 46% and highly significant."

So when one is dealing not with a 20%, for example, standard rate, but a reduced rate of, say, 5% that one sees, for example, for domestic electricity supplies, the pass-through rate is half, at least half of what you would say is the UK-wide economy rate for pass-through?

A. Yes. Well, I would just note this is one study that we are looking at. In fact, there are a very large number of studies that have looked at the pass-on of VAT which I discuss in my report. If you look across all of these studies, you tend to find that the vast majority of them find a very high level of pass-through, generally around 100% for VAT increases.

Q. Can we look in Mr Ramirez's second report, which is his positive case {RC-F/8/26}. Can we look, please, at paragraph 56 in this report. He gives an example of a varied reaction to an increase in a cost common to mass market apparel retailers in the form of the 2011 VAT increase in the UK.

I am not going to read it, because I think -- is it marked as confidential? Maybe it is not. It has my highlighting on it which has confused me.

It then says, and I think I can read this out:

"M&S indicated that the VAT increase would be automatically applied to new products in its stores ... with the prices on some existing products 'being changed in stages over time' ... However, Primark indicated that its profits were lowered through its decision to absorb some of the margin pressure caused by the 2011 VAT increase and increased cotton prices. While caution should be exercised in assessing statements by retailers on their pricing intentions, these statements are public responses to a visible cost increase and ... provide an indication of how M&S and Primark may approach a cost increase differently."

Do you see that?

A. Yes.

Q. That is one of the sources of evidence we have about how firms might deal differently with VAT. The other is also found in this report, page 81, please {RC-F/8/81}, paragraph 217.

Here we have a contrast with the steps that Primark took following the VAT increase -- VAT change in 2008. It is not in fact the same one we have just seen. There was a 2008 VAT change which I think led to lower VAT and Mr Ramirez is contrasting that with the reaction to the 2015 MIF change. You can see, can you not, from that chart, Chart 11, that there is a very significant distinction in the change in the prices of products.

THE CHAIRMAN: Can we just go down. Thank you.

(Pause)

MR BEAL: In fairness to you, at 218, I think I ought to point out, reading through, paragraph 218, page 82, Mr Ramirez says:

"For the avoidance of doubt, this analysis does not rule out the possibility that the reduction in MSC costs was passed on at a later date (assuming the overcharge was in fact passed on). However, the potential for later pass-on does not detract from the conclusion that the Primark did not react to the 2015 ... decreases in the same way it reacted to the 2008 VAT decrease."

So he is there suggesting, is he not, that taking VAT as an example can lead to a false analogy, in practical terms, because the reaction of a large company like Primark may be very different to a change in MSC levels compared to a change in VAT levels?

A. Well, I think, as Mr Ramirez notes, this analysis is sort of incomplete, in the sense that it is looking at what happened in the short-run, it is not looking at what happened in the long-run.

I think there are -- there is also the problem that this is attempting to do what I think all of the experts in this case have agreed is not really a viable approach, which is to try and identify the cost pass-through of the MSC directly, and we have all agreed that that is not possible due to the signal to noise ratio, and therefore one has to look at a proxy.

So I think, for those reasons, I personally would not place, you know, a great deal of weight on this evidence.

Q. Now, in any event, you have not selected VAT as a suitable proxy, have you?

A. No.

Q. Can I then please come on to price adjustment issues. In your thirteenth report, please {RC-F/10/60}, paragraph 2.103, you refer to the menu costs issue.

A. I just note that to get to page 60, we skipped through the large number of studies that have actually examined the impact of VAT increases that I was referring to.

Q. I am coming on to public studies, but not immediately. Empirical studies, academic studies.

At page 60, please, 2.103, you refer to the menu costs issue, is that right, price adjustments? It is right, is it not, that price adjustment costs are more likely to deter price rises for very small changes in costs, other things being equal?

A. In the short-run, yes.

Q. So your response, as I understand it, is essentially look to the long-run. In the long-run, all costs to have to be recovered. Is that right?

A. Well, it is a bit more than that. The point is -- so what we are talking about here is menu costs or other transactions costs that a firm incurs when it changes prices. So in deciding whether to change price, there is a question about, well, will the extra profit that I gain from changing my price be actually outweighed by the menu costs of doing so? If that is the case, then you will not bother changing your prices.

Now, in the short-run, that is more likely to happen, because you are thinking about, well, what is going to be the benefit over a short-run period? But if you have a price change which is sustained for a long period of time, the longer the price increase is sustained, then the more the benefit from changing prices, and therefore the more likely it is that you will increase prices because the benefit of doing so will outweigh the menu cost.

Q. But in terms of the separate point about, well, in the long run you will recover all your costs, you would accept, would you not, that generally costs recovery as an economic concept does not establish pass-on?

A. You are saying that cost recovery --

Q. General cost recovery over the long-run does not equal proof of pass-on, does it?

A. Well, it depends what you mean by cost recovery. If you mean cost recovery by increasing prices, then that is

pass-on. If you mean cost recovery by some other mechanism, then that might not be pass-on.
Q. So in order to establish cost recovery that had led to an increase in prices, you would need to point to a specific increase in prices, would you not?
A. Yes.
Q. Now, if we could look in your fourteenth report, please, at paragraph 2.129(b) {RC-G/9/70}. The paragraph we are looking at specifically is 2.129(b). There you say, four lines up from the end of that paragraph:
"More generally, a quick and discernible response to changes in MIFs or MSCs is also not to be expected ..."
So you would accept, would you not, that you are not likely to be able to show a direct change in prices downstream as a result of a change in either the MIF or the MSC?
A. Yes.
Q. You are not in a position to point systematically to any direct increase or decrease in prices charged downstream as a result of changes in the MSC, even over the long-run period that you are looking at?
A. Yes.
Q. Can we now please move on to recurrent cost. This involves having a quick look at what you say about it. It is {RC-F/10/61}. This is your thirteenth report,

paragraph 2.110.

The point you make here, as I understand it, is -- well, you say in terms:

"MIFs and MSCs have changed infrequently and mostly by small amounts only."

That is your general proposition?

A. Yes.

Q. Are you aware of the significant change in MIFs that was associated with the Visa commitments in January 2015?

A. Yes.

Q. Are you aware of the significant changes in everyone else's MIFs from December 2015 with the IFR caps?

A. Yes.

Q. Are you aware in April 2019 that Visa and Mastercard cut their inter-regional fees in accordance with the commitments they gave to the EU Commission?

A. Yes.

Q. Are you aware that, following Brexit, in 2021, over the course of 2021, both Mastercard and Visa increased interchange fees for card not present UK EEA transactions?

A. Yes. I would just ... in case it is not obvious, all of these events are after the end of the Merricks claim period.

Q. But not after the end of the SSH claim period?

A. No.
Q. In terms of that last one, the Brexit change, for card not present UK EEA transactions, the change was from 0.2% to 1.15% as a MIF; correct?
A. Yes.
Q. For credit cards, it was 0.3% to 1.5%?
A. Yes.
Q. So that is essentially a five-fold increase, is it not?
A. Yes.
Q. Difficult to say that is anything other -- within the context of admittedly a small cost, it is difficult to say that that is not a significant change in the MIF in relative terms?
A. Yes, that is a significant change in the MIF, I agree.
Q. Moving on to the next topic, which is the smallness of the MIF, or the MIF as a small charge in absolute and relative terms, you would accept, I think, that one of the economic characteristics of a cost is both its absolute and relative size?
A. Yes.
Q. Can I infer from that that you are undeterred from that fact by choosing a proxy that is the sum of total costs incurred by a business?
A. Well, this is the -- it comes back to this point, the challenge here. So if we are all agreed that you cannot

actually identify the impact of the MSC directly because of the signal to noise ratio, it is too small compared with everything else that was going on at the same time, then by definition, if you are going to choose a proxy, you need to choose a proxy which does not have the same problem. So if you chose a proxy which is the similar size, then you are not really solving that problem.
Q. Well, you have stated, I think, that the small magnitude of the MSC does not imply that it will be ignored. Can I suggest to you that for at least some businesses, the size of the MSC was exactly so small that it simply did not move the dial on pricing issues.
A. Well, I think this takes us back to what we were discussing yesterday and the point that small cost changes accumulate and, to the extent that they lead to a pivotal moment when there is a change in cost, all of the cost changes that have contributed to that cost change are contributing to that change in price.
Q. Of course, by picking, by definition, the largest measure of costs that a business faces, and equating that with a very small cost, you must acknowledge you are at risk of skewing the results of your analysis very firmly in favour of pass-on, are you not?
A. Well, I do not agree with that, and I would note that when I did the analysis of the merchant data I looked at

total cost, and for most of the merchants, possibly all of merchants, I also looked at just looking at more direct costs as well, and I did not find that that led to a significantly different result in terms of pass-on rates.

Q. Could we look, please, in your thirteenth report {RC-F/10/62}, in particular at footnote 182 at the bottom of the page. You say here:

"MSCs may not be separately identified but they will of course be detected and hence captured somewhere within the firm's reporting structure. If they change, then the cost category they form part of will change and through that route they will affect pricing decisions."

Just pausing there. So you are recognising, I think, that there is no direct mechanism by which the MSC will feed into a short-run pricing change; correct?

A. Depends what you mean by "direct mechanism". I mean, the point here is I am not saying that somebody is directly monitoring the MSC, but they are directly monitoring a cost category that the MSC forms part of.

Q. We know, I think, from the witness evidence that we have seen and from the -- putting to one side the fact that you have not really addressed that head-on, we know from the evidence that the Tribunal has heard last week that most of the analysed claimants treat the MSC as an

overhead?
A. Yes.
Q. So, logically, you would look to see how they were dealing with the overhead cost bucket in order to understand how they were treating that type of cost?
A. Yes. I would -- if I can just add a point. We were talking a moment ago about the distinction between an ad valorem and a fixed per unit cost, and of course that is relevant here. Because if the scenario we are thinking about is a situation where what the business is doing is they are not monitoring the MSC directly, instead they are monitoring a wider cost category, and most of, if not all of, the other costs there are not ad valorem, then when they react to the change in that cost, obviously they are not going to react in a way that is specific to an ad valorem cost, such as the MSC; instead, they are going to react in a way that they would react to any change in cost.
So, in that situation, the fact that the MSC is an ad valorem is not going to factor into the business's decision-making, because they are not reacting to the change in an ad valorem cost, they are reacting to a change in a wider category of costs.
Q. So, on that analysis, you would suggest, would you not, that the very steep increase in the relative size of the

MIF for credits cards from anyone other than a UK national post-Brexit, so what we were describing as in the inter-regional fee for card not present going up by a factor of 5 in 2021, on your analysis one would be expecting to see that taking form, would we, in Hilton's pricing decisions this year, next year? When do we think that is likely to hit?
A. Well, I am not going to speculate about how that is going to feed through into -- in terms of the exact point in time when an individual merchant is going to make a decision to change its prices. What I am saying is it will feed through in some way, either because they are monitoring the cost, or because of the impact that that, along with other changes in cost, have on their net margin.
Q. Those costs, say, first six months, first half of 2022, where the price impact is being experienced, that is going to be replicated, is it not, in the management accounts, to the extent that the MSCs are included in a bucket of overhead costs that Hilton has in its management accounts; correct?
A. So it is going to be -- so if the MSC is part of a wider cost category and the MSC changes, then, yes, that has an influence on that wider cost category.
Q. That will feature in the 2023 statutory accounts that

Hilton's filed for its various hotel entities?
A. Yes.
Q. But you are saying that might not necessarily have been captured in the pricing at that stage?
A. Yes. I am saying that these small changes in cost accumulate and at some point they have an impact, but I am not saying exactly at what point in time I would expect them to have that impact.
THE CHAIRMAN: Are you saying that, because of the small size of the MIFs, we are only talking about the long-run? Your theory does not work in the short-run, because there's no direct mechanism for the MIFs having an effect on prices?
A. Well, I probably would not go that far, and I think it depends how you determine -- how you define the short-run and the long-run. The point I am just making is I am saying that you would not expect there necessarily to be an instantaneous reaction, that there is likely to be a delay because it is likely to only have an effect when it is accumulated with other changes in cost.
MR BEAL: That applies, does it not, even if the MSC is a specific line item in the Sage accounting software under a higher level bucket of costs of selling and general administrative expenses or operating costs or

payment charges, whatever the nomenclature may be within the accounting software. It may be expressly visible somewhere on an Excel spreadsheet, but it is not going to factor directly into the pricing mechanism, is it, because it is an overhead and not a COGS?

A. Yes, so it is going to factor in -- it is not going to factor in, in the sense of having an immediate impact on prices, but it will factor in over a period of time by influencing the overall level of overheads.

Q. Can I move on to look at specifically how the MIF or MSC is treated as a cost. Now, just dealing with this at a sort of high level for a moment. Can we look, please, in your thirteenth report {RC-F/10/53}, paragraph 2.85. It starts on the previous page {RC-F/10/52}.

Right at the bottom of the paragraph before the footnotes:

"... [agreement that] MSCs are variable costs. The expert for ... SSH ... considers that the more important question is whether merchants treat the MSC as a direct input or as an overhead. However, in my view whilst that treatment may affect the speed with which MSCs ... are reflected in prices, I do not consider it likely that this treatment has a bearing on whether pass-on occurs at all ..."

Then you give some reasons.

Could I ask you, please, to look at {RC-J1.4/19/35}. This is part of the European Commission Guidelines. Can we pick it up, please, at paragraph 161. Perhaps you can read to yourself 161 and 162 and then I will put a point to you. (Pause)

So the Commission is recognising, is it not, that the treatment by the purchaser of the costs, and indeed the timeframe over which the particular purchaser takes into account those costs, are relevant factors in the analysis?

A. Well, it is saying that it is -- what is relevant here is whether the cost is fixed or variable and how the firm treats these different types of cost.

Q. Could we look, please, in your thirteenth report {RC-F/10/53}, at paragraph 2.86. This is coming back to look at the first of the reasons you give. You say:

"First, a classification of MSCs as overhead ... does not alter the fact that this cost varies with output and ... therefore [it is a] variable cost. A change in the MSC will affect the cost of supplying additional units of output and should, therefore, according to economic theory, affect the firm's pricing decisions."

You are not, however, as I understand it, saying that this is a classic variable cost that will be plugged in as a COGS that goes into the direct pricing mechanism in the short-term; correct?

A. No. The point I am making is that the nature of the cost, as to whether it is fixed or variable, is, you know, an objective fact, either the cost is fixed or variable, and that does not change depending upon how it is categorised in the firm's account. If it is a variable cost, it is still a variable cost.

Q. But if the firm has no distinction in its corporate head between variable versus fixed costs, and what it cares about is cost of goods sold, which fed into the gross margin which drives the pricing decisions, on the one hand, and then overheads, which is a bucket of fixed, semi-variable and variable costs on the other, does it matter whether or not, as a matter of economic theory, it is truly fixed or truly variable?

A. Well, I think the point I am making, which I think is possibly agreeing with what you are saying, is I think there are two ways that one can look at this. One can look at it on the basis of economic theory, in which case you are looking at objective facts as to whether a cost is fixed or variable, or you can look at how firms treat a cost in their accounts and their pricing decisions, but we need to be sort of careful about the terminology here. When we are talking about how firms treat costs in their accounts and pricing decisions, they might distinguish between cost of goods sold and overheads, but that is not the same as distinguishing between a variable cost and a fixed cost. They are sort of different concepts.

So I think we just need to be -- you know, avoid the confusion of thinking about, if something is categorised as an overhead, that means it is a fixed cost. That does not turn it into a fixed cost, it just means that in terms of how the firm analyses the cost it is treated as an overhead, rather than cost of goods sold.

Q. Can I put it the other way round, which is that the way a firm deals with costs is much more important than whatever the economic theory might suggest the costs should be pigeon-holed as?

A. Yes, but I think then that raises the question as to whether -- you know, what evidence do we have? Maybe this is a difference between Mr Merricks' claim and the merchant claims. Because for Mr Merricks' claim, what is important is how every merchant across the UK economy, what they did, and what in practice we have is we have evidence from a relatively small number of individual firms.

So I think the question is whether one can extrapolate from a small number of individual firms who have been not chosen in a process in order to make themselves representative. Of all of those thousands of merchants across the economy, they have been chosen in a pragmatic way in the basis of the merchant claims. Can we extrapolate from the experience of those merchants to merchants across the rest of the economy? I think that is the question I am raising.

Q. Can we look in your fourteenth report, please {RC-G/9/34}, paragraph 1.73. Here, right at the bottom of the page:

"As explained above, in my view the most relevant cost proxy for the MSC is total costs as I want to estimate the long-run pass-on of the MSC."

You then say:

"While the MSC is clearly a variable cost, some merchants may treat it for accounting purposes as an overhead cost and hence a part of total costs."

So you are recognising, are you not, that the way the merchants actually treat the cost in practice is a meaningful factor to take into account?

A. Yes.

Q. The difference between us is we say the relevant proxy is therefore total overhead costs, because that is the bucket in which it falls, and you are saying, no, it has to be total costs, full stop. Correct; that is the

difference between us?
A. Yes.
Q. But by doing that, you are bundling into your proxy, on a long-term analysis basis, costs which are necessarily cost of goods sold; correct?
A. Yes.
Q. I think we have recognised that the treatment of cost of goods sold, certainly in the short-run, is subject to a much more direct mechanism in terms of its impact on pricing?
A. In the short-run, yes.
Q. Of course, when Dr Trento used your model, and indeed his own, to model for total overhead costs rather than total costs, he found that the pass-on rate was significantly lower, did he not?
A. Yes.
Q. That has nothing to do with the long-run, that is simply using your model but factoring in a total overhead cost proxy rather than a total cost proxy?
A. Yes.
Q. What, with respect, your analysis fails to explain is how we get from a very direct short-term immediate pass-on, as we saw in the VAT example, the VAT decrease or the VAT increase, to a pricing mechanism whereby prices change over the long-run.

A. Sorry, if I can just go back to your previous question. You said that what Dr Trento is looking at is he is looking at the pass-on of overhead costs in the long-run, but what he is looking at is he is looking at data from merchants in terms of identifying the overhead costs, and I think, in general, the data that we have from the merchants is over a relatively short period of time.
Q. Six years.
A. Yes. So I think it is less clear --
Q. How much longer do we need?
A. Well, in case -- well, it varies between the different merchants, but I am just making the point that I do not think we can automatically assume that the analysis that we are doing for the individual merchants is capturing long-run effects. It might be capturing short-run effects.
Q. Now, of course, some merchants have gross margin targets, do they not? They may have a cost price -- basis for pricing where they look at the COGS and they say, right, we want to achieve 30 or 40% on top of our COGS. That would be a gross profit margin basis for pricing; correct?
A. Yes.
Q. Any cost that is treated as an overhead will not factor

into that process, will it?

A. Well, it is included within the margin target, in the sense that the margin target is set in such a way that it is going to both cover all of those overhead costs and leave a profit that is available to pay interest and pay returns to shareholders.

Q. But, of course, having a target and achieving it are two different things, are they not?

A. Yes.

Q. So you must accept the merchant evidence that where MSCs are not a direct input into prices, that target margin may or may not happen to recover a particular bundle of costs in due course?

A. Yes. Well, that will, in the short-run, be the case. Obviously firms do not always achieve what they set out to achieve. But if that -- if you are consistently not achieving your margin target, then you are going to do something about that.

THE CHAIRMAN: This is a net margin target?

A. No, it is a gross margin target. So you have -- so a firm has its cost of goods sold, and then there is the gross margin above that.

THE CHAIRMAN: Yes.

A. If they are setting prices based on: what is my cost of goods sold and I need to set a price that reflects those cost of goods sold, but obviously I am not just going to recover a price that just cover those costs, I need to recover those costs, plus I need to recover a margin above the cost of goods sold to cover my overheads and profit and interest and so on.

So it is that difference between the cost of goods sold and the price that you are achieving, that is the margin that we are talking about here, and you have a target for that margin, and the target is based on, well, this is what I think my overheads are, this is what I think my interest payments are going to be, this is what I need to pay to my shareholders, this what I need to pay in incorporation tax, and so on, and that determines how big that margin target is.

PROFESSOR WATERSON: Can I just come in here? So you have said several times that the small costs will add up?

A. Yes.

PROFESSOR WATERSON: Together they will have an impact at some stage?

A. Yes.

PROFESSOR WATERSON: So you have identified a theoretical mechanism, if you like.

A. Yes.

PROFESSOR WATERSON: But do you have instances where you can point to that theoretical mechanism playing out in

practice?
A. No.
PROFESSOR WATERSON: Thank you.
MR TIDSWELL: Can I ask you about extrapolation, just to pick up something you said about that before, about extrapolating the evidence we have to the wider population.
Would it be reasonable, do you think, to assume there is an option for firms to treat the MSC either as an overhead or as effectively cost of goods sold in the gross margin calculation; it is probably one or the other, would that be right?
A. Yes.
MR TIDSWELL: Do you think it is also reasonable to assume that it would have to be a reasonably particular circumstance to treat the MSC as being part of the gross margin calculation, because it is a small size and it is associated with payment costs; in other words, it actually is probably going to be more usual to treat it as overhead. Is that a reasonable assumption?
A. Sorry, I got a bit confused there.
MR TIDSWELL: Sorry, that is my fault. Let me try it again.
It seems to me that we have seen some examples where firms treat the MSC as effectively cost of goods sold for the purpose of their pricing, a gross margin

exercise in pricing, we have seen that, but they do seem to be reasonably specific situations. So we are talking about, I think, online platforms in particular. But for most merchants, it is unlikely, it would seem, to be put into that category, because for most merchants it is going to be an incident of payment costs which they are more likely to treat as an overhead. Is that a reasonable assumption in your view to make, if one is thinking about the generality of firms?

A. Yes. Well, it is not a -- well, it is not a conclusion I would personally sort of draw. I would say that, as you say, when one looks at the evidence in front of us, we have examples where merchants have treated it as cost of goods sold, and we have more examples where it is treated as an overhead.

I think what you are suggesting is that the situations where it is treated as cost of goods sold are somehow special cases and they are not going to be representative of the rest of the economy. To be honest, I do not really feel able to know whether that is the case or not.

MR TIDSWELL: Well, I suppose it is an enquiry as to why a merchant might treat it one way or the other, and whether they would bother treating it as cost of goods sold unless it was very material to their business, and that seems unlikely for most businesses. I think that is the logic behind the question.

A. Well, I would certainly agree that for most businesses this is going to be a very small cost, and if they do not treat -- if they do not include very small costs in their cost of goods sold, then they will be unlikely to do so. So, on that logic, that would be the conclusion, but obviously that is speculation.

MR TIDSWELL: Thank you.

MR BEAL: Could we look, please, at {RC-J1.4/19/29}. This is part of the Commission Guidelines that leads directly on from the Tribunal's questions, which is the distinction between what theory might suggest and what one should take into account in the real world.

Could I invite you, please, to read recitals or cast an eye over recitals 123 through to 127 on that page. (Pause)

Could I perhaps put three propositions to you and see whether or not you are prepared to accept them, once you have had time to digest.

The first proposition is that a proxy may not be a good one if it is more sizeable than the affected cost. Would you agree with that as a proposition?

A. The problem is that just creates a circularity problem, because then it becomes impossible to estimate pass-on.

If you are saying I have to use a cost which is the same size as the cost which is too small to detect an impact on price, then you are never going to detect an impact on price, so that just becomes circular, I think.

Q. Are you familiar with parable of the drunk man looking for his keys under the street light and a policeman comes up to him and says, "Can I help you, sir?" The drunk man says, "I have lost my keys". The policeman says, "Well they are not here. Where did you lose them?", and the drunk man says "Well, I lost them over on the other side of the street but there is no light there".

So the consequence of what you are suggesting is you look for a cost that is not a good proxy in order to give an answer, even though it is not going to answer the right question?

A. Well, the alternative is that you cannot -- you know, you just say there is no proxy that I can use, and then you cannot do anything.

Q. Then you cannot prove pass-on; correct?

A. Well, it means that you -- that the -- yes, you are basically saying, you know, it is never possible to prove pass-on in any situation.

Q. No, I am not suggesting that at all. It is just not possible in this case to prove pass-on on these facts?

A. Or you are saying it is not possible to prove pass-on of a cost of this magnitude.
Q. Well, we have proved pass-on at enquiry state in the IC++ contract, because the MIF has been passed on by the merchant acquirers to my clients. That is an example of indirect pass-on, is it not?
A. Yes, but that is a different situation, in the sense that the MIF is the vast majority of the acquirer's cost.
Q. That is my point.
A. What you are saying is when you have a cost of a similar size to the MSC in terms of its proportion of the cost of the merchants, then it would never be possible to establish pass-on.
Q. The second proposition is that firms may not pass on smaller costs in the same way as they pass on larger costs, do you accept that?
A. If by "the same way" you mean the speed at which they pass on, then yes.
Q. The mechanism or indeed the speed?
A. Yes.
Q. The third point is that it is therefore advisable to take into account qualitative evidence?
A. Yes.
Q. It is fair to say you have not taken into account the

qualitative evidence in this case other than, as I understand it, one reference to the evidence of Mr Matthew Day of Travix.

Can we look, please, at {RC-F/10/54}. What you say at 2.91(b) is -- well, you give some evidence from Mr Matthew Day as to what you say he says. Do you think that that is representative of the totality of the evidence given by Travix to this Tribunal?

A. Well, you are suggesting that this is the only evidence that I have looked at in my second report. I also look at some of the other evidence from the merchant claimants.

Q. Would you say that this is a fair summary of the factual position that Travix finds itself in?

A. In the sense that it treats --

Q. Well, you had better not talk about the detail?

A. Okay, let us not talk about the detail. Well, I believe it is a -- you know, it is a direct quote from what he says.

MR BEAL: Sir, that may be a convenient moment to take the ten-minute transcriber break.

THE CHAIRMAN: Yes. Ten-minute break.

(11.40 am)

(Short Break)

(11.50 am)

MR BEAL: Mr Coombs, I am going to move on to touch briefly on the distinction between marginal costs and fixed costs. Can we look, please, at {RC-J1.4/19/34}. Again, back to the Commission Guidelines 2019. Could you cast an eye, please, over recitals 158 and 159. (Pause)

Now, as a matter of economic theory, I think you would agree, would you not, that there is a distinction between the short-run marginal cost approach, direct mechanism into pricing, and a longer run appreciation of fixed costs, which will typically affect long-run strategic decisions, do not get directly fed into the short-run pricing process?

A. Yes.

Q. If we look, please, at what you say about our case, that is {RC-G/9/28}, so your fourteenth report, paragraph 1.43. You say that:

"Dr Trento, among others, does not treat these as conceptually variable costs but effectively is treating them as fixed costs."

Can you see that allegation?

"Based on their reviews of such evidence, the experts in question conclude that merchants have mostly treated MSCs as fixed costs."

A. Sorry, which paragraph?

Q. 1.43, the last sentence. (Pause)

A. Yes.
Q. Now, that is not right, is it? Dr Trento has accepted that conceptually the MSC is a variable because -- a variable cost because it varies with output. But what he said is that merchants do not treat it as a cost of goods sold which would be equated with a marginal cost; correct?
A. Yes.
Q. In terms of how we go about looking at this, given that you have accepted, as I understand it, that the direct marginal cost route into pricing is not one that is likely to be met, except in the odd case when one might find it on the facts, then you really have to look at a mechanism for pass-on, do you not, in the longer run?
A. So --
Q. You have accepted, I think, that given that the firms are treating it as overhead and not as a COGS, it will not feature in the short-run marginal cost approach to pricing?
A. Yes. I think this is where we have to distinguish between economic theory and evidence from the merchants. So the merchants are saying -- well, most of the merchants that have provided evidence on this say that they treat the MSC as an overhead, and therefore one has to think about how overheads feed through into pricing.

Q. You are not, I think -- I may be wrong -- suggesting that somehow that short-run pricing mechanism applies equally over the long-run and therefore is the way that, as you would describe them, fixed costs are dealt with?
A. No.
Q. So therefore one has to look, does one not, pragmatically, at what is the -- how does the particular merchant or the particular sector treat a cost?
A. Yes. So I think you used the word "pragmatic" there which I agree with. So this may be sounding rather sort of purist about this, but I think one has to distinguish between if one is analysing this based on economic theory, in terms of how are variable costs and fixed costs passed on, because then the MSC is clearly a variable cost, or are we doing what you described as a pragmatic approach, that we are looking at evidence from the merchants and thinking about how do they treat it in their decision-making process. So I think we have to be clear as to which path we are going down.
Q. Well, could we look in your fourteenth report at page 60 {RC-G/9/60}, paragraph 2.79.
As I understand your evidence, and tell me if I am wrong, you have not any anywhere suggested that there is this direct route into pricing on a sort of mechanistic cost-plus pricing method with the MSC. That is not your

evidence?
A. Well, what I have said is that if you want to analyse this as a matter of economic theory, then the MSC is a variable cost. But obviously if you want to analyse it in terms of the decision-making process within a firm based on the evidence that some of the claimants have provided, then you need to think about it in those terms.
Q. Well, in 2.79 we are dealing with the evidence basis before the Tribunal, which is the vast majority of analysed claimants say these are overhead costs, and your response is overhead costs are passed on in the long-run. Can you see that?
A. Yes.
Q. Then what I am trying to ascertain with you is what is the mechanism in practice whereby that pass-on will take place, and what you are positing here is that it might be indirectly through the treatment of gross margins. Is that right?
A. Yes.
Q. The other way you look at this, at 2.83, page 61 {RC-G/9/61}, paragraph 2.83. The other way you look at this is to say that merchants typically pass on changes to variable costs more quickly than fixed costs, given that variable costs directly impact short-run pricing

decisions. So you seem to be saying if this were a COGS, we could expect it to be more priced more quickly and get fed into the short-run pricing decisions. In contrast, fixed costs would remain constant. However, in the long-run, you say, all costs become variable. In the long-run, costs that were fixed in the short-run eventually need to be passed on. So, as I understand it, your response for those overhead cases is to say, well, look, even in the long-run, they are necessarily going to have to be recovered; correct?
A. Yes.
Q. But in the meantime you have identified, have you not, that fixed and marginal costs will be passed on at different speeds over that long-run period?
A. Yes.
Q. So you would need to have an explanation of the mechanism by which part of an overhead cost, if it is variable, will be passed on immediately in the short-term, and the rest is passed on at some unspecified date in the future, for overheads?
A. Well, I think -- I am not sure that one needs to distinguish between overheads depending upon -- I am not really quite sure what the distinction was. You seem to be drawing a distinction between two different types of overhead, whereas I think all I am doing is saying if it

is treated as an overhead, it will still get passed on in the long-run.
Q. I see. So you do not bother to split out variable overheads over fixed overheads; you do not worry about that distinction. You just say, well, they are all total costs, they will be recovered in due course?
A. Yes.
Q. Right. Can I move on to deal with qualitative evidence. I have covered an awful lot of this territory already with you. I mean, it is right, is not it, that you have not chosen to focus primarily on merchant data, in particular where public data is available?
A. Yes.
Q. You have noted that M&S, for example, provided over 1 billion observations. So the problem in a sense is not that the data is there, it is just you prefer to use the public data for the reasons you have already given?
A. Yes.
Q. We established yesterday that you consciously chose, for example, not to use the Hilton data, again for the reasons we have already been through?
A. Yes.
Q. Have you now looked at the oral evidence that was given to the Tribunal last week?
A. No.

THE CHAIRMAN: I think it was two weeks ago.
MR BEAL: I am sorry, time flies when you are having fun!
A. Sorry, you said the oral evidence. So I have seen some of the oral evidence, for example, given by Mr Holt, but I think you are specifically referring to oral evidence given by --
Q. Witnesses of fact.
A. Given by Hilton, or ...?
Q. Yes.
A. So I have not looked at that, no.
Q. Fine. Can I move on to the timeframe, so short versus medium versus long-run.
Now, as I understand it, you suggest the analysis should take place over the long-run exclusively, is that right?
A. Yes.
Q. So if you were adopting a slogan, it would be: what do you want? 91% pass-on. When do you want it? In due course. Is that fair?
A. I am not saying I want a particular number for pass-on, I am just investigating what the data shows.
Q. You cannot point us to a particular point at which a given level of pass-on would have been executed by a group of my clients, can you?
A. No.

Q. Your approach essentially is premised entirely on the fact that you do not need to worry about that for Mr Merricks' claim, as I understand it, because that claim ended so long ago, there is sufficient clear blue sky between the end of the claim period and where we are now, that you can infer that one way or another those costs must have been passed on by now?

A. Well, I am not -- well, I suppose maybe I would answer that differently. So what I have been asked to do is look at the level of pass-on in the context of Mr Merricks' claim. So, strictly speaking, what I am not trying to do is to analyse the level of pass-on today, I am trying to analyse the level of pass-on during Mr Merricks' claim period. Now, in practice, to get there, I use evidence from some of the merchants, and obviously that is recent data, but I use that in order to infer what the pass-on would have been during Mr Merricks' claim period.

Q. Well, imagine somebody has started a claim in 2021 and it is part of these proceedings, that would not cover your long-term period, would it?

A. No.

Q. So I am assuming from the answer you have just given you would not be able to show pass-on for that particular claimant?

A. Well, what I could do is I could estimate what effectively would be the short-run level of pass-on for that claimant, and I would expect that short-run level of pass-on to be lower than the long-run level of pass-on. So in that sense, it gives some evidence about the level of pass-on.
Q. Say somebody had started a claim in 2009. It is a substantial period of time ago. At what point between 2009 and now do you say that pass-on is likely to have occurred?
A. Well, I do not give an opinion on exactly when pass-on would have occurred in that situation, no.
Q. Now, we know, for example, that MIF rates for consumer cards have been the same since 2015 because of the impact of the IFR; correct?
A. Yes.
Q. Your theory, as I understand it, would have predicted that by now, 100% of that MIF reduction should have been passed on to consumers; correct?
A. Well -- sorry, are you talking about what I am saying in terms of economic theory, or are you talking about what I am saying in terms of the empirical analysis that I have conducted.
Q. I thought the two overlapped and ran in parallel, but if there is a distinction between them, then please do

explain.
A. Well, what I would say in terms of economic theory is I would expect there to have been a high level of pass-on, so not necessarily 100%, but maybe close to 100%. Then in terms of what I found empirically, I have estimated a pass-on rate of, as you say, 91%.
Q. Okay. So on your case, one should have seen evidence, should we not, of 91% of that reduction in the MIF being fed through into lower prices charged by the retail economy?
A. Well, there might be some asymmetry here, in the sense that pass-on might not be symmetric in both directions, so --
Q. This is the rockets and feathers point?
A. Yes.
Q. Where does your theory/analysis cater for asymmetric responses to cost increases or decreases?
A. No, I have not looked at asymmetric effects, no.
Q. You are not trying, as I understand it, to try and imply that there is a short-term marginal cost pricing calculus that gets carried over to the long-run. That is not your analysis?
A. No.
Q. So what you do not do, as I understand it, is imply some sort of price-cost trade-off just taking place over the

longer term? Price-cost; ie I can raise my prices but it will lead to reduced demand, reduced volume, the sort of classic marginal cost analysis that one looks at in the short-term?

A. Well, maybe just to clarify ... I am now a bit confused about your question.

So in terms of when I am looking at -- when I am looking at the mechanism in terms of how pass-on takes place, and in the context where if one assumes that it is not -- the MSC is not treated as COGS, it is treated as part of overheads, I am saying, well, there is a mechanism by which that cost can be passed on in the long-run.

Q. But it is not the same mechanism as the short-run marginal cost pricing dynamic?

A. No.

Q. Can I move on to the question of choice of proxy cost. Now, your preferred proxy is total costs; that is right, is it not?

A. Yes.

Q. That means you capture, on your analysis, both variable and fixed costs?

A. Yes.

Q. On a pragmatic approach, you cover cost of goods sold and overheads?

A. Yes.
Q. It will cover overheads whether they are variable, semi-variable or fixed?
A. Yes.
Q. Would you accept that different rates of pass-on are likely for each of those if they are, in fact, treated differently by a firm?
A. Well, you might in the short-run get different rates of pass-on, yes, but you would expect in the long-run that they would all be passed on.
Q. You see, one of the criticisms Mr Holt made of your analysis was to suggest that it would provide a skew downwards on pass-on rates, because you have bundled together cost of goods sold with overheads. Are you familiar with that criticism?
A. Yes.
Q. Now, if you have ended up with a figure that is even higher than Mr Holt's, that would imply, would it not, that if you stripped out the overheads element, the conclusion you would reach on COGS alone would be much higher statistically?
A. So Mr Holt is saying that what I am estimating is a pass-on rate which is an average of COGS and overheads, and he is saying if the pass-on rate for overheads is lower, then the pass-on rate for COGS will

be higher than whatever number I have estimated. Is that the point you are making?
Q. Yes.
A. Yes.
Q. So statistically that follows, does it not?
A. That follows if Mr Holt is correct that there is a difference between the pass-on rates.
Q. Yes, and in fact you have used public data for the proxy costs where you use the COGS as a measure, do you not?
A. Yes.
Q. So if Mr Holt is right, your analysis of the proxy cost of COGS is going to drive a much higher implicit pass-on rate than Mr Holt's analysis would do on public data?
A. Yes. But as I said, I do not expect there to be a difference in the long-run.
Q. As I understand it for -- the consequence of that analysis would be that if you accepted that overheads, total overheads, was the right proxy, then your estimates have necessarily overstated the pass-on rate if that is the correct proxy?
A. Yes, but obviously I do not believe that that is the correct proxy, yes.
Q. Now, for merchant data, as I understand it, you sum together variable and overhead costs to give a total costs figure, is that right?

A. Yes.

Q. You have then suggested that this could be an underestimate. This is {RC-G/9/35}, 1.74(b). You say:

"However, the merchant data covers a shorter time period over which fixed costs may not yet have been passed on to the same extent. As a consequence, the pass-on rate I estimate may underestimate the long-run total cost."

A. Yes.

Q. But, of course, if we are focusing on overheads, your estimate would have overstated it, would it not?

A. Yes.

Q. Now, if variable costs are the most significance cost for a business, such as COGS, you would, other things equal, expect the pass-on rate to be higher; correct?

A. Sorry, can you repeat the question?

Q. Yes. If variable rates are the most significant cost for a business, such as --

A. Do you mean if variable costs are the most significant cost for the business?

Q. Yes. If variable costs are the most significant cost for a business, such as the cost of goods sold, then you would expect the pass-on rate for those costs to be higher?

A. Yes.

Q. So by necessarily adding in COGS to your total cost proxy, you are driving up the pass-on rate; correct?

A. Well, I would expect that in the long-run these pass-on rates would be the same, is the approach that I am taking.

Q. Can we look the next paragraph in Coombs 14, please. That is 1.75. As I understand it, you have allocated overhead costs according to a methodology, so that they are aggregated with the same level of variable costs. Can you just explain to me how you have done that?

A. How I have allocated the overheads?

Q. Yes.

A. Yes, well, this was discussed yesterday. What I have done is I allocated the overhead costs across different products in proportion to the -- to COGS. So, you know, if hypothetically one product represented 10% of COGS, then I allocate 10% of overheads to that product.

Q. But you had pricing data for each of those products that you were allocating costs to. Why did you not use the pricing data for the products in order to give a revenue-based analysis to the allocation?

A. Yes, I explained this yesterday. The problem is that that creates a circularity, because then your allocation is driven by the price level, so the whole thing becomes circular as a result.

Q. That is what I wanted to pick up. I do not understand why that should be the case. Are you familiar, in VAT, with partial exemption methods?

A. I am not, no.

Q. So the concept in VAT is you have standard-rated supplies of goods and you have exempt supplies of goods -- it is perhaps easier with services -- and you have to bundle together the input tax that you are recovering that is attributable to standard-rated supplies where you get full recovery, and exempt supplies where you get zero recovery, and there is a category of residual goods, typically overheads, where you have to work out what proportion of those overheads is due to standard-rated supplies and what proportion is due to exempt supplies.

The standard method for performing that allocation is to rely on a revenue split between standard-rated supplies and exempt supplies. With me so far?

A. Yes.

Q. So there is nothing circular there, is there, about using an allocation process for overhead costs? It is simply giving a metric that is objective and capable of easy calculation.

A. Yes, but that is a different context, is it not? So I think the point here -- I explained this yesterday.

From an economic perspective, there is no perfect way of allocating overheads across costs, but typically the two options are either on the basis of the proportion of costs or the proportion of revenues, and which approach you use will vary depending upon the context.

Now, in this context the problem is if you allocate them on the basis of revenues, then effectively you are creating a relationship between revenues and costs in the way that you have allocated the costs. So, of course, you are going to have -- you are going to -- you are creating a correlation between costs and revenues in the way that you have allocated costs, because you have allocated costs on the basis of revenues, but, by definition, you have correlated them; that is how you have sort of constructed the allocation.

So then if you use those costs which have been allocated on the basis of revenues and are already correlated with revenues, if you then try to measure what is effectively the correlation between costs and revenues, you have sort of inflated the relationship that you are estimating because of that. That is the circularity that I am describing.

So that is why I did not use that approach, because it would be likely to overestimate the pass-on rate. Instead I used the approach which avoided that possible

overestimation of the pass-on rate.
Q. Could I look at the implication and outcomes of your choice of proxy cost. Now, it is right, is it not, that by selecting total costs, you have necessarily increased the likely visibility of that cost as a component in the pricing decisions of a company?
A. So, yes, total costs will be visible, yes.
Q. Direct costs here have typically been provided by merchants in the form of very disaggregated data, have they not?
A. Yes.
Q. Whereas operating costs have been provided at the more aggregated level?
A. Yes.
Q. That implies, does it not, that greater attention is generally paid in the real world to costs that are directly related to price than to those which are factored in only indirectly?
A. Yes.
Q. Can I turn, please, to the issue of sectorisation. Just to confirm, the classification of a given SSH claimant to a given sector is not something that troubles you, is it? It is not something you have looked at it?
A. Well, I have looked at it just for the purpose of noting that they are -- things may have changed, because I know

cases have settled in the meantime. But I did look at this at one point in time and identified that there was at least one, I believe actually more than one, SSH claimant in each of the 12 sectors that I define, but that was purely just to identify that they cover the space. I was not doing it in -- for the purpose of saying that you should then apply a particular pass-on rate to a particular SSH claimant, if that is what you are getting at?

Q. Your sectorisation approach, as I understand it, is based on data from the UK Card Association, is that correct?

A. Yes.

Q. That data is reported by banks and merchant acquirers?

A. Yes.

Q. Did you contact the UK Card Association to seek an explanation for the categorisation they have adopted?

A. No.

Q. I assume that merchants do not select the sector they are assigned to within that framework?

A. I am sure they do not. Well, I do not know, but I think it is very unlikely that they would, no.

Q. I think it is fair to infer, is it not, that the categorisation is not done to try and group together merchants who are likely to pass on the MIF overcharge

at similar rates?
A. I agree.
Q. Now, you have ended up with telecoms in the same sector as educational establishment, such as universities; correct?
A. Yes.
Q. You have conducted some analysis of Three that I will come on to a bit later on, but you have not conducted any analysis of the University of Manchester data, have you?
A. No, I have not.
Q. You end up, do you not, with the position where florists and pawn shops are in the same retail goods sector as, for example, pharmacies and pet shops?
A. Yes.
Q. I think you would recognise that necessarily produces highly aggregated results?
A. Yes.
Q. In a sense, your answer to that is: well, I am trying to find a highly aggregated result, namely the UK pass-on rate; correct?
A. Yes.
Q. You would accept, would you not, that some of the catch-all sectors are very broad indeed?
A. Yes.

Q. You chose not to use the Visa or Mastercard sectors?
A. No. Well, I mean, just to explain the reason I have not used their sectors is the data for those sectors, the data on the volume of card transactions, which I then use as weights, is only available for recent years, it is not actually available for the Merricks claim period, so there will be no value in using those sectors.
Q. What were you criteria for extrapolating from a sub-sector to a sector? Was it simply within the existing division on the UK Card Association?
A. Sorry, I am not quite sure what you mean by extrapolating from a sub-sector to a sector.
Q. If you have identified, as you have sometimes, a sub-sector, is that always within the hierarchy of a sector that is given to you by the UK Card Association?
A. Yes.
Q. So it is not that you have conducted a separate sub-sectoral analysis?
A. No. They define a sector, and within that sector they define the sub-sectors, and I have used their definitions.
Q. Can I move on, please, to the role of academic studies. You have not identified any academic studies dealing with the pass-on of the MSC, have you?

A. No.
Q. Many of the studies relate to the implications for tax and excise duty for alcohol and tobacco products?
A. Some of them do, yes.
Q. So the studies likely focus on the trade-off between public health, for example, and the tax take, which is the typical legislative issue when trying to work out whether to increase taxes on cigarettes and alcohol; ie you want a public health benefit but you are worried that suddenly the tax will not be paid, and you need the tax to be paid?
A. So are you saying that the purpose of a study is to --
Q. (Overspeaking - inaudible)
A. -- which is then used by policy-makers to make those decisions?
Q. Correct.
A. Yes, I am sure that is the case.
Q. This is not just me speaking for myself as a result of this trial, but demand for both cigarettes and alcohol is likely to be fairly inelastic, is it not?
A. Yes.
Q. Could we look, please, at {RC-J6/31/1} which is a study by Bergman and Lynggard. We see there an abstract -- tab 33, sorry, not 31, page 1 {RC-J6/33/1}. It talks about are excise taxes on beverages fully passed through

to prices, and there is some Danish evidence.

We see the extract on the next page, please {RC-J6/33/2}:

"... studies ... shifting of excise taxes ... We find that excise taxes on beer and soda are overshifted but those on liquor are undershifted."

So that is the take-away; correct?

A. Yes.

Q. Could we then please look in a different paper, Ally et al {RC-J6/10/1}. This is looking at alcohol tax pass-on rates. Effective use of alcohol duty. Findings in the abstract. Within all four categories there exists considerable heterogeneity in the level of duty pass-through. Level of undershifting is greatest for beer.

Then:

"Alcohol retailers in the United Kingdom appear to respond to increases in alcohol tax by undershifting their cheaper products [ie beer] and overshifting their more expensive products [ie liquor]."

So you get diametrically opposed conclusions, do you not, between those two papers? One says excise duty leads to overshifting for beer but not for spirits, undershifting for spirits, and the other says undershifting for beer and overshifting for liquor?

A. Yes.
Q. It is fair to say that at the very least, these studies do not all speak with one voice, do they?
A. No.
Q. Are you aware of the paper that I put to Mr Holt from Ioannidis who talks about the risk of publication bias?
A. I am aware of the risk of publication bias, yes.
Q. As I understand it, you have not looked at academic studies in the UK on the pass-on of overhead costs of a comparable size to the MSC?
A. No.
Q. Could I then please look in your thirteenth report at paragraph 1.24(a) {RC-F/10/13}. Here you are passing out, ie analysing on what basis you are going to sift the academic papers that you have been considering, is that right?
A. Yes.
Q. You are concentrating essentially on three factors, as I understand it. Firstly, studies that focus on industry-wide costs?
A. Yes.
Q. I am not going to repeat with you the discussion as to whether or not the MIF is an industry-wide cost. We then see the second criterion is studies focusing on the long-run, is that right?

A. Yes.
Q. Again, I will not repeat with you the debate about whether this is a short-run or long-run approach.
    Then, finally, you focus on cost increases, studies on cost increases; correct?
A. Yes.
Q. You have not, for example, found any papers that deal with, for the sake of argument, the decrease in the MIFs following the IFR in 2015?
A. No.
Q. Can I suggest to you that you sensibly have not relied upon the figures produced by academic studies in order to find a reliable estimate that this Tribunal could rely upon to conclude what the pass-on rate should be for any of my clients?
A. Correct.
Q. Can we then please move on to public data. Now, I would like to deal with this in stages. Firstly, some general issues about public data.
    Now, you have used the Consumer Price Index to measure prices, save for the RPI which you use for automotive fuel; correct?
A. Correct.
Q. The basket of products for the CPI is modified each year?

A. Yes.
Q. So it captures changes in the typical consumer basket?
A. Yes.
Q. So, for example, mobile phones would have been a small item in 1992. Music, CDs and tapes would have been much higher?
A. Yes.
Q. Are you aware -- I found out this on the internet the other day -- vinyl has come back in, into the CPI basket in 2024. It has made a surprising re-entry. Were you aware of that?
A. If you saw my son's bedroom, you would not be surprised.
Q. The short point I am making, and it will not be lost on you, is we are not measuring the same basket of goods from year to year, are we?
A. No, we are measuring -- what the ONS is trying to do is to try to measure an equivalent basket of goods, recognising that goods come in and out.
Q. That is an aggregated figure covering a vast multitude of different products?
A. Yes.
Q. As I understand it, you have not been able to find a single cost indices or measure which will capture the evolution of total costs in any of the 12 sectors you examine, is that fair?

A. That is -- well, my approach was to make sure I was covering the majority of costs, but, yes, you are correct that it does not cover the totality of costs.
Q. So to get a higher level of coverage where it is appropriate, you have had to splice together data from different indices?
A. Well, specifically in some sectors, I combine a PPI, which is measuring cost of goods, and an index of labour costs.
Q. I do not mean this uncharitably, but it is therefore not a real world variable, is it? It is a Frankenstein economic variable that has put together two different proxies and combined them, albeit it on a weighted basis, no doubt?
A. You might be surprised that I want to put it slightly differently to that, which is what I am trying to do is trying to reflect that some of these businesses, the two most important components of their costs are costs of goods and labour, and therefore I have tried to create an index that reflects that.
Q. The first of the indices you use is the PPI, the Producer Price Index, is that right?
A. Yes.
Q. As I understand it, you have not used the import PPI at all. I thought you had, but you told me, I think

yesterday, that you had not?
A. No. The point is -- well, originally I would have intended to do so, but when I looked at the import PPIs, they all start relatively recently. None go back far enough for me to be able to use them.
Q. The second index that you use is SPPI, is that right, which measures the price of services?
A. Yes.
Q. But you have only used that for the travel sector?
A. Yes.
Q. The third is the Average Weekly Earnings index which we explored in some detail with Mr Holt; correct?
A. Yes.
Q. That is an estimate of average earnings per employee per week?
A. Yes.
Q. Calculated by dividing the total -- weighted total of pay by the total weighted employment?
A. Yes.
Q. That does not produce a price in the form of an hourly rate, does it?
A. No.
Q. The PPI output essentially captures the main changes in the cost of goods made by producers, does it not?
A. Yes.

Q. That is likely, typically, to tell us what the typical price charged for a good at manufacturing or wholesale level is?
A. Yes.
Q. There is a separate PPI input for manufacturers, is there not?
A. Yes.
Q. But you have not used that measure?
A. No, because that would be the wrong point in the supply chain. What I am trying to capture is the price that is paid by -- effectively by retailers or service providers, and so the index that you are referring to would be instead the cost that is paid by a manufacturer when they are purchasing an input from another manufacturer, so it is not the right index to use for my purposes.
Q. The PPI and CPI measure different things, do they not?
A. In the sense that they are -- do you mean in the sense of the coverage of the products that they cover, or do you mean in the sense of where they are in the supply chain?
Q. Both. The CPI measures price increases for domestic sales of domestically produced goods and imports?
A. Yes.
Q. Whereas the PPI only measures the price of domestically

produced goods or the cost?
A. Yes.
Q. Now, please can we look at {RC-F/10/97}, this is your thirteenth report, at 3.110. I think, to be fair to you, you have acknowledged here, have you not, that producing a composite cost index may be an imperfect way of measuring the evolution of costs?
A. Yes.
Q. But you preferred to do that rather than relying on the direct disaggregated data from the merchant firms because your task was to produce a UK-wide figure?
A. Yes.
Q. Now, you have also used, I think, PPI where COGS is the most significant component of costs as a proxy. Is that right?
A. Yes.
Q. You have used the Average Weekly Earnings index where labour costs are likely to be the most significant component for service industries, and so on?
A. To be clear, where wages represent the majority or roughly 50% of costs, then I have used wages on its own. Where COGS is 50% or more of costs, I have used the PPI on its own. Then in some other sectors I have used the combination of the two.
Q. So what your analysis will establish is a correlation

between either COGS or labour costs and changes in
price?
A. Yes.
Q. If the MIF is not a key variable cost, the PPI measure
is not going to reflect that cost, is it?
A. Well, this comes back to the point about the fact that
I am trying to identify a proxy for the MSC. I am not
measuring the MSC directly, I am identifying a proxy.
Q. Do you accept that the PPI will measure factors which
may be influenced by a change in the CPI?
A. In what way do you mean?
Q. If there is an inflationary pressure on the CPI which
leads to a general increase in prices, that could then
feed into a change in the underlying index of the PPI,
because it also is a cost component indirectly in some
of the PPI costs that are generated at manufacturer
level?
A. So if you are thinking about at a sort of
contemporaneous level, then that is a possibility. But,
as I explained yesterday, my model is a lagged model, so
what I am using is I am using prices in the future as
a function of costs in the past. So it is unlikely that
the prices are influencing the cost.
Q. A change in the CPI might, for example, trigger a change
in wages. We have seen that recently, have we not, with

wages responding to price inflation as a result of both the invasion of Ukraine and the mini budget?
A. Yes.
Q. So that would also establish a degree of reverse causality for the AWE, would it not?
A. Yes. But, as I say, the way my model is constructed it avoids that problem.
Q. How have you dealt with other explanatory variables in this public data analysis? How have you dealt, for example, with the shock caused by the invasion of Ukraine?
A. Well, that is after the period that I am examining. My analysis stops in 2019. The reason it stops in 2019 is deliberately to stop before the Covid pandemic and the invasion of Ukraine to avoid that influence in the data.
Given the period that I use, which generally starts in either 1996 or 2000, up to 2019, the main event that would have affected demand during that period was the financial crisis, and therefore I have controlled, for the financial crisis, where I have found that it had an effect.
Q. So that is the only variable you have used on a sort of exogenous economy shock basis, the financial crisis?
A. In terms of a demand shock, yes.
Q. But, as I understand it, you have also inserted ad hoc

modelling choices to deal with particularly difficult years on a dummy variable basis as well, have you not?
A. Well, where there are -- well, so I have used dummy variables to address, for example, seasonality in the data, and I have also used it where there are particular outlier observations which are affecting the analysis, which I think we discussed over the past two days.
Q. Now, to derive your pass-on rates for most of your public data analysis, you estimate pass-on elasticities and then multiply them by the gross retailer margin. Is that right?
A. Yes.
Q. That is an average retailer mark-up?
A. Yes.
Q. That conversion rate will not be sector-specific, will it?
A. No, it is sector specific.
Q. Now, you said on Tuesday that you were not able to go back to 1992 for your conversion rates. Do the SUTs not go back that far? I thought you used the SUTs for your conversion rates.
A. Yes. But what I have done is I have used data which is contemporaneous with the data that I have used. So if I am using data from 1996 to 2019, then I have used a conversion rate which is contemporaneous with that

period.
Q. In terms of merchants who provided --
PROFESSOR WATERSON: Do you mean a conversion which is different each year or an average conversion rate?
A. An average.
PROFESSOR WATERSON: An average?
A. Yes.
MR BEAL: Where merchants provided data with revenue excluding VAT, I understand you have added the VAT back in. Is that right?
A. Yes.
Q. Could I refer you, please, to {RC-G/17/57}. This is part of Mr Holt's twelfth report, paragraph 167.
He is comparing your estimates of pass-on based on public data and Mr Holt's estimates from the closest comparable analysis.
"Mr Coombs' estimates of pass-on range are generally consistent with high pass-on. Where we have analysed the same sector we obtained broadly similar results."
Can you see that?
A. Yes.
Q. But Mr Holt has counselled, has he not, about the general imprecision of estimates based on public data, because he says in the last sentence:
"Where we have analysed the same sector we obtained

broadly similar results, particularly when one considers the general imprecision of estimates of pass-on based on public data."

Which he has previously discussed.

Do we find a similar recognition by you of the general imprecision of conducting public data analysis?

A. Well, I discuss those particular, you know, limitations of the data where that is appropriate. Obviously any econometric analysis involves some degree of imprecision, and that is why I conduct statistical tests in order to assess the reliability of my results.

Q. Could we look, please, at {RC-F/19/130}. This is Mr Holt's eleventh report and it is Table 6.1.

We have there, do we not, an identified P-value of the pass-on elasticity, which indicates pretty clearly through bold entries the results that Mr Holt considers to be statistically significant?

A. Yes.

Q. Have you conducted a similar table exercise to show where your public data analysis is also not statistically significant?

A. Well, I set out -- for each sector where I set out the results, I explain the statistical test that I have used and what the results of that statistical test are.

Q. For the non-statistical results, you would not be able

to derive a reliable pass-on estimate, would you?
A. Well, that is not necessarily correct. The fact that a regression does not produce a statistically significant result does not mean to say that the result necessarily should be completely ignored. But I would say that, you know, in general my results are statistically significant. So I report the results and I identify where they do not pass the relevant statistical test, but generally the results I rely on are statistically significant. They pass the relevant test.
Q. Your analysis of statistical significance, as I understand it, is contained in the sectoral tables by reference to a bounds test, is that right?
A. Yes.
Q. Now, in terms of simultaneity bias, ie reverse causality, you would agree, would you not, that producers in the UK are generally aware of what the inflation rate is and might have expectations on where the inflation rate is going in the future?
A. Yes.
Q. Could we look at a recent study from the Bank of England {RC-J1.6/137/2}. We have the abstract here:

"... paper analyses the response of firms to monthly CPI inflation releases using high frequency data ... CPI inflation perceptions respond very quickly, in a matter of hours after the release. We also find that firms' expected own-price growth has a strong positive correlation with changes in CPI inflation ..."

So if we could then please turn to page 28 {RC-J1.6/137/28}. There is a recognition, under a paragraph that begins, "Column 4 ...", there is a recognition, is there not, that this analysis applies regardless of whether it is industry-wide or sector-wide, ie market-wide? So they say:

"The relevant analysis shows that the effects of CPI releases are significant at 5% both for sectors which cite CPI inflation as most important and those which do not."

So anyone who is in an industry that is saying we recognise CPI as an important business factor we take into account is in one sector, and then people who do not think it is significant are in the other, but their responses nonetheless are statistically significant in responding to expected changes or announced changes of the CPI index; correct?

A. Yes.

Q. You suggested, and you have repeated it this morning, that your lag model overcomes any concern about this circularity, this reverse causality issue, between the

CPI and the PPI. Is that right?
A. Yes. Well, maybe it does not completely overcome it, but I think it largely deals with it, yes.
Q. But if one looks at the relationship between contemporaneous CPI and PPI in the same time period, pass-on estimates would likely suffer from that bias, would they not, simultaneity bias?
A. They would be more likely to suffer from the bias, yes.
Q. So you would not know whether or not the dependent variable was influencing the independent variable or the other way round?
A. No.
Q. Could we look, please, at {RC-F/10/239}. This is in your thirteenth report, starting at paragraph 4.302. We may need to go just to the top of the previous page to put it in context {RC-F/10/238}.
So for the travel agent sub-sector, you have then prescribed an econometric model. Can you see that?
A. Yes.
Q. Then the model is at the top of the next page. You have included there, have you not, price measured at the time, T, and cost measured at the same time period, T?
A. Yes.
Q. In your equation. You are therefore comparing, are you not, prices and costs within the same time period?

A. But I am also comparing -- I am also including the lags as well.

Q. Could we look, please, at {RC-J1.6/78/1}. This deals with the risk of reverse causality bias. We see at page 2 there is the abstract {RC-J1.6/78/2}. The authors looked at the relationship between two inflation indices, Consumer Price Index and Producer Price Index, for Mexico and found that the causality running from PPI to CPI exemplifies the cost push nature of inflation, and the opposite is the indicator of the demand for inflation (inaudible) relationship in the short periods and the longer periods. So they have looked at the impact of using CPI and PPI-type indices both in the short term and longer term, and they still find the risk of reverse causality; correct?

A. Well, what they also say is they say there is an asymmetry here. So they say that the impact of the CPI on the PPI only occurs in a shorter period of time, whereas the impact of the PPI to the CPI occurs over a longer period of time.

Q. Moving on to controlling for admitted variables. Not controlling for demand would be an admitted variable bias, would it not?

A. Yes.

Q. Where have you controlled for demand in your public sector analysis -- public data analysis?

A. Well, as I have said, what I have done is I have excluded the Covid period and I have controlled for the financial crisis, which are likely to be the main effects on demand during the period that my data covers.

Q. Could we look, please, at {RC-F/10/104}. This is in your thirteenth report at paragraph 3.135. You say there:

"The regression approach does not need to account explicitly for other factors that are theoretically relevant, such as intensity of competition, the nature of demand and supply or the existence of price adjustment costs."

Because, essentially, you say they are going to be implicitly dealt with in your analysis. Is that right?

A. Yes.

Q. But would you agree that there are -- there is an impact that demand can have on the price of a product that is not directly related to the specific cost of the product?

A. Well, I think there are two different points here. So, one, what this is talking about, this is talking about the factors that vary across different sectors. So nature of demand can vary across different sectors. So effectively the slope of the demand curve or the elasticity of demand may be different across different sectors, and I am saying to the extent that that is the case, it will be captured in the empirical analysis.

There is then a separate point, which is as to whether, over time, there have been demand shocks which might in some way influence the pass-on relationship, and it is those demand shocks that I control for, either by excluding the relevant period from the data analysis, or by controlling for it, if it occurs during the data -- the period of data analysis.

Q. Well, let us give you an example. Imagine during the 2012 Olympics in London, companies started charging more to clean hotels, in the anticipation that there would be a higher demand for cleaning services for hotels, and separately from that there was higher demand, full stop, for hotel rooms, because there was a greater demand for a scarce quantity of hotel rooms in the city of London. So those are two separate factors.

If you do not somehow control properly for demand, you could end up with a position whereby the demand -- sorry, higher costs associated with cleaning costs is attributable to a different demand than pure price demand for the hotel, could you not?

A. You could -- well, I think there are maybe two points that are relevant here. One is it is always inherently difficult to control for demand in these models, because often you are faced with two choices. So one is that you control for demand using a measure which is specific to the sector that you are analysing, but then you have a potential endogeneity problem, that you do not know whether it is demand that is affecting prices or prices that are affecting demand. So that is the difficult there.

The alternative is that you use something which is much wider, which may not actually be accurately reflecting what is happening in your sector. What I do is essentially more of the latter, in the sense that when I identify that there is something which is very significant, like the financial crisis, I introduce a control for it, but what I do not try to do is introduce sector-specific demand controls, because then that introduces an endogeneity problem.

Q. In terms of matching CPI with either PPI or AWE, could we look at how you have dealt with this, please. So for price costs and wage indices, you have selected the closest matches that you can find, is that right?

A. Yes.

Q. Can we look, please, in your thirteenth report, paragraph 4.92 {RC-F/10/168}. We have there the CPI of restaurants and cafés, is that right?

A. Yes.
Q. That is what you have chosen. The PPI is then dealt with in paragraph 4.96 over the next page -- sorry, two pages down, page 484 -page 170 sorry {RC-F/10/170}. Paragraph 4.96, we see that the index that you are specifically using for this is PPI index output domestic, sub C10 to C12, food, beverages and tobacco, including duty. Can you see that?
A. Yes.
Q. The PPI of food, beverages and tobacco therefore includes sectors -- SIC sectors C10 to C12, is that right?
A. Yes.
Q. Those are manufacturing sectors; correct?
A. Yes.
Q. They are involved with things such as the manufacture of prepared feed for farm animals or the manufacture of tobacco products. Do you know that?
A. Yes.
Q. Would you say that the manufacture of tobacco products is a direct cost that restaurants pass on to their customers?
A. What I am trying to do here is I am trying to select the index which I think is -- closely matches -- most closely matches the CPI that I am using. So I am not

claiming it is a perfect match, I am saying I am trying to identify the one that is the best match.

Q. Can we look then, please, at the travel sector. That is {RC-F/10/235}. That is in your thirteenth report at 4.290. The CPI measure is package holidays, can you see that?

A. Yes.

Q. Could we then go forward, please, to page 237, paragraph 4.297 {RC-F/10/237}. The PPI measure is -- well, you have SPPI, output domestic, passenger air transport services, and then AWE, administrative and support services activities index. Can you see that?

A. Yes.

Q. The administrative and support services AWE index includes wages in renting and leasing of trucks, disinfecting and extermination services, and furnace and chimney cleaning services. Are you aware of that?

A. Yes, but it is also the -- it is the index for the SIC codes which also includes travel agents, so therefore it is the one that -- if you are going to choose one for travel agents, this is the one that covers travel agents.

Q. But you would accept, would you not, that wages earned by rat-catchers are not likely to be relevant to the cost of travel agents?

A. Obviously this is an average across lots --

PROFESSOR WATERSON: (Inaudible)

MR BEAL: I suspect it may depend on the hotel!

A. It is an average across different activities. I think the point I have already made is that generally labour markets are likely to be wider than some of the sectors that I am examining here.

Q. More generally, there is a risk of mismatch or measurement error, is there not, in you approach, because, for example, a supermarket selling Italian wine and French cheese would have those prices included in the CPI, but those inputs would not be reflected in the domestic PPI?

A. Yes.

Q. In terms of the speed of pass-on, when estimating price elasticities -- pass-on elasticities using public data, you have estimated the speed of the pass-on; correct?

A. Yes.

Q. That is what you call the adjustment coefficient?

A. Yes.

Q. So if there is a change in cost, the adjustment coefficient will measure the percentage of that cost change that translates into a price change in a given time period?

A. Yes. Well, to be specific, what it is doing is it is measuring the speed of adjustment to the long-run trend, so it is an error correction model. So what it is doing is it is estimating a long-run trend and then it is estimating what you might call the error correction, so it is the adjustment from wherever you are in the short run to the long-run trend, so it is rather pejoratively called an error. You might say, well, it is not really an error, it is just a difference between where you are in the short run and the long-run trend and it is measuring the speed of adjustment from that short run position to the long-run trend.

Q. Now, a 1% adjustment rate would suggest that if costs change, then prices change by 1% of that cost change every time period you select; correct?

A. Yes.

Q. The time periods you select are months?

A. Yes.

Q. Can we look, please, at {RC-F/10/173}. This is your thirteenth report, at paragraph 4.106. For restaurants there, under subparagraph (b), you report an adjustment coefficient of between 0.4% and 1.4%, is that right?

A. Yes.

Q. This means, does it not, that it would take around 100 months for prices fully to reflect the cost change?

A. Yes. This was -- well, I was asked about this by

Mr Cook yesterday, I think. I think the point is that, you know, this is possibly the most extreme case. When you look at the other sectors, the adjustment mechanism is much quicker than in this case.

Q. Well, let us look at vehicle services you deal with, I think, as well, do you not? I think, for the purposes of putting the point I need to put to you, I can just deal with this one sector. I think the figures for travel agents is 7%, vehicle services is 1%, but --

THE CHAIRMAN: I think we did go through this with Mr Cook.

MR BEAL: We did, so I do not need to dwell on it, but the consequence of this is that you are -- well, let me put it this way: you would not really be able to suggest confidently that there was a causal link between a change in cost and a change in price that happens 100 months later, would you not?

A. No, that is a very slow adjustment but, as I say, like Mr Cook, you are choosing the two sort of most extreme cases. When you look at the other estimates, the speed of the adjustment is much quicker.

Q. I am going to move on, in the time available before the short adjournment, to deal with surcharging and possibly supplier pass-on, because I am making good progress. You generally have not considered the issue of surcharging, have you?

A. No.
Q. You do not think it was a prevalent practice?
A. During the Merricks claim period, no.
Q. So you do not think it is a relevant issue when analysing a potential UK-wide pass-on rate?
A. Well, the reality is that when I am estimating the UK-wide pass-on rate, to the extent that there was surcharging, that should be captured within the overall pass-on rate in any case.
Q. Could we look please in your thirteenth report {RC-F/10/134}, paragraph 3.262. You have indicated that regulations -- regulated sectors may operate differently. However, you thought that these would be implicitly reflected in price. I think we went through this a bit yesterday. You accepted that you had not looked, for example, at university fee regulation?
A. No -- well, precisely because of the way that the fees are regulated, I did not look at the data from the University of Manchester.
Q. Then in your fourteenth report, please {RC-G/9/173}, this is your fourteenth report at paragraph 3.358, you have simply dropped any analysis of data in the education sub-sector because of your concern that the treatment of MSCs by universities would not be representative. Is that fair?

A. Yes. Well, no -- well, actually the reason is slightly different. The reasoning is that the rate of pass-on that you would estimate from data for a university whose domestic fees are regulated is not really going to tell you very much about the rest of the sector that I am looking at, which is the other services sector, so I did not look at the University of Manchester because I thought the pass-on rate I estimated did would not really be representative.
Q. So you dropped it from the analysis when it was likely to dent the pass-on figure?
A. No, the opposite. The concern is that it would overestimate, so if I can explain this. If you think about a university, they have their fees for domestic students are regulated, they are capped, and they are not capped on the basis of cost, they are just capped for -- well, I understand effectively to be political reasons that they have capped at the same rate for a decade or so. So suppose this university faces an increase in costs, it cannot increase its fees to domestic students but it can increase its fees to overseas students and I think post-graduate student fees are not regulated.
So the analysis -- so if I was to do an analysis for the University of Manchester that focused on the fees

that can go up, it is likely that there has been sort of disproportionate pass-on. If you cannot increase your fees to domestic students, the way that you recover the increase in your cost is by increasing your fees to overseas students by even more in order to recover from them the increased costs, not just on overseas students but also on domestic students.

So my concern was that if I used data from the University of Manchester I would overestimate the pass-on rate that would be relevant for the rest of the other services sector, so that is why I did not look at data from the University of Manchester.

Q. You have therefore not tested that hypothesis on the real world data that the University of Manchester has provided?

A. No. Well, I took the view that, you know, I had to choose who I was going to spend my time investigating so there were some merchants, such as the University of Manchester, where I, well, I would investigate, I would estimate a pass-on rate and then I would say this pass-on rate if not really relevant and helpful and that would just be a waste of time and a waste of money.

So I did not do that. I focussed on estimating pass-on rates where I expected that the results were likely to be useful.

Q. The next topic is supplier pass-on. Have you got anything you want to say on supplier pass-on?
A. I do not know. Given it is three minutes to one --
Q. I was rather hoping you would go short.
A. I do not know. I mean, do you have a specific question?
Q. No, I do not have a specific question. I am giving you open mic. That may be dangerous; we will see.
A. I am quite happy to decline the open mic, yes.
MR BEAL: I am about to move on to the analysis of the merchant data. In the two minutes available, can I make some very short high level points.
Firstly, the regression of my clients' own data does not by itself establish a causal relationship between cost and price, does it?
A. Well, I think regression -- okay, one ends up with the cliché that, you know, correlation is not causation. I think the point about regression analysis is that it can tell you more than just that there is a correlation. If the regression analysis is based on a model that is based on economic theory, so it suggests that you might plausibly expect causation and you control for other relevant factors that might be influencing the correlation, then it is possible that the results of a regression analysis are informative about causation that they do not just tell you about correlation.

I think that is the way I would put it.
Q. Now, again, at a general level, you have chosen to exclude the Covid period for some of your analysis; correct?
A. Correct. I think mostly what I do with the merchant data is I look at the two alternatives. So for the public data, I have enough data that I can simply exclude the Covid period. For the merchant data, obviously it is more recent data so it is more difficult to do that so for most merchants what I do is I look at two alternatives. In one alternative I exclude the Covid period and then the other alternative I control for the Covid period. I think in virtually every case where I do that I find that the pass-on estimate is lower if I exclude the Covid period and I then rely on that lower estimate when I exclude the Covid period.
MR BEAL: Thank you. That is probably a convenient moment.
THE CHAIRMAN: I do not know where we are on your list of -- we did not get a number.
MR BEAL: No. I am on number 14. So, without giving away state secrets, I have about ten or 12 pages of notes which means --
THE CHAIRMAN: Obviously we did go through quite a lot of the merchant data with Mr Cook.
MR BEAL: Yes. I am not planning on going sector by sector.

THE CHAIRMAN: Okay, great.

PROFESSOR WATERSON: Can I just ask a question or raise an issue. You said just now that where a model uses economic theory, then correlation can be argued to be causation.

A. I think I said it is informative about causation.

PROFESSOR WATERSON: Okay, it is informative about causation, but yesterday we saw, with Mr Cook, that in some cases you added in dummy variables in a very ad hoc way. So are you as confident in those cases that what you are establishing is causation or is it simply you have found a correlation?

A. No, I think it is still informative about causation. I think what you are trying to do is you are trying to identify some underlying relationship in the data and in order to do that you have to control for confounding factors and sometimes you have a prior belief that there is a confounding factor. In some cases you just find that there are anomalies in the data, which may be due to some unknown factor or may actually be due to some problem in the way the data is constructed.

So I think -- I do not think the fact that you have to control for those factors reduces the information that the regression is producing.

PROFESSOR WATERSON: But you simply do not know whether

there is some underlying problem in the data or whether you have just tried to fit a relationship?
A. No. Well, yes, there is some uncertainty there, yes.
PROFESSOR WATERSON: Thank you.
THE CHAIRMAN: Thank you. 2 o'clock then.
(1.00 pm)
(The luncheon adjournment)
(2.00 pm)
MR BEAL: Mr Coombs, please could we go to your fourteenth report, Table 24 {RC-G/9/186}. What we have here is an overview of your revised estimates of sectoral pass-on rates.
If we look at the column with merchant data, it is fair to say that those figures are almost uniformly smaller than the estimates you produced based on public data. Is that fair?
A. Well, maybe -- yes, maybe on average they are. I would not say that they uniformly are.
Q. Well, simply looking at ranges, we have 36.9% through to 108% for merchant, but with the bulk of them being well under 100%. Then for the others, obviously it tells a different story, does it not, in the first column?
A. Yes, I mean, I am being pedantic here. You said "uniformly", which would imply that all of the merchants' estimates are below all the public data

estimates, and that is not the case. But I would agree with you that it looks like, on average, the merchant data results are lower than the average for the public data results.

Q. Strike "uniformly", replace "predominantly".

A. Yes.

Q. You have then looked at triangulation results for some of the sectors, have you not, so it gets built in twice over?

A. Yes.

Q. Now, you have preferred public data, as I understand it, for essentially three reasons. This is in your thirteenth report {RC-F/10/84}. At a very high level, at risk of summary, your first reason is paragraph 3.71, namely that you did not have much time to do this. Is that fair?

A. Yes.

Q. Dr Trento, Mr Holt and Ms Webster have all produced regression analyses for merchant claimants who provided full datasets, have they not?

A. Yes. Well, they have made different choices about how to prioritise the use of their time.

Q. Your second reason is at page 86 {RC-F/10/86}, paragraph 3.75. You say there are some potential risks from over-reliance. Can you see that?

A. Yes.
Q. Essentially, this splits into two reasons, does it not, reason 2(a) and reason 2(b). Reason 2(a) is that the merchant data will contain firm-specific costs, as well as market-wide costs, and you are only interested in the latter. Is that right?
A. Yes.
Q. Now, the reason you care about that is that firm-specific costs, on your analysis, are less likely to be passed on than the market-wide cost increase; correct?
A. Yes.
Q. When you say market-wide cost, you mean a cost that is common to all participants in the market; correct?
A. Yes.
Q. So, for example, coffee beans in the coffee sector, going into the price of a latte from the high street coffee shops?
A. Yes.
Q. When you say firm-specific cost, you mean the cost that is not common to all but only borne by some in that particular market; correct?
A. Yes.
Q. That would be, for example, the price of oat milk in the coffee shop sector if a substantial proportion of coffee

shops did not offer oat milk lattes?
A. Yes. Perhaps I should clarify that what is relevant here is the cost change, because that is what I am analysing is the cost change. So you could have a cost, an input that is common across all the firms in a market, but only one of them suffers an increase in that particular input. So it is not just to do with whether everybody purchases this input, it is to do with whether they all incur the same change in the cost.
Q. Can we see how you put it at {RC-F/10/9}. This is your thirteenth report, paragraph 1.14(c)(i).
Scrolling down to (c)(i), you say:
"Pass-on rates are normally expected to be higher for a cost incurred by all competitors (a market-wide cost) than for a cost incurred by only one or some competitors (a firm-specific cost)."
So in the example I have just given you, some competitors would incur a firm-specific cost of higher oat milk prices but not all competitors in that market would?
A. Yes.
Q. So that would be -- oat milk would be an example of a firm-specific cost. The coffee beans, because it is borne by all competitors in that market, would be a market-wide cost?

A. Yes.
Q. Do you consider that this difference that you identify, there is a risk of understatement of pass-on, because there are a bucket of firm-specific costs in the overheads category, do you think that is a material or significant issue in terms of the likely difference it will make to the pass-on percentage?
A. Well, I am saying it is a risk. I have not quantified what impact that has. I feel I have no way to quantify the size of that input, but I am pointing out that it is a risk.
Q. So you cannot actually tell us what the significance of it might be?
A. No.
Q. Now, you also say, in your thirteenth report at paragraph 3.75(a) {RC-F/10/86}, that as the pass-on rate estimated for merchant data is an average between the corresponding pass-on rates of market-wide and specific costs, this may underestimate the pass-on of the MSC; correct?
A. Yes.
Q. But we do not know, do we, what you expect the difference in rates to be?
A. No.
Q. Could we look then, please, at {RC-G/9/186}, going back

to the public data in your Table 24. You have there estimated, have you not, pass-on rates in respect of eight of your 12 sectors and in circumstances where, as I understand it, two estimates are under the heading "Sectors without suitable or sufficient public data", where that data relates only to subsectors in the broader sectors, is that right?
A. Yes.
Q. In some of your public data, proxies do not include only market-wide costs, do they?
A. Yes.
Q. So AWE, for example, includes within it measures of wage costs which are not going to be borne by every person who is in that market?
A. Well, they are -- sorry, I did not quite follow the question. You are saying that the cost is going to be borne not just by people in the market, but also by firms outside of the -- well, we are talking about sectors here -- not just by firms within the sector but also by firms outside of the sector?
Q. No, I mean within the market of Average Weekly Earnings there will be an average of wage earnings that will be reflective, perhaps, of somebody who works in the hotel industry, but will not be reflective of somebody like a specialist chef who works in a restaurant?

A. Yes, so it is an average, so it is not going to be representative of every firm within the sector. It is an average that is wider than the sector.
Q. In relation to those eight estimates we have been talking about, all but two of them are above 100%, are they not?
A. Yes.
Q. In terms of travel, which is one of the two that is below, we see that it is 87.5% based on public data; correct?
A. Yes.
Q. So if there is a material difference between the pass-on rates of market-wide and firm-specific costs, which would lead ex hypothesi to a significant increase in pass-on, then your pass-on rates would be even higher, would they not? So if your public sector data has included firm-specific costs in it, you end up with an even higher figure if that is said to be material?
A. No. Well, that is not what I am saying. What I am saying is I am saying that where I look at the public data, I am looking at costs which are common across the sector, and I think the point that you have been making is you are saying some of these costs actually go wider than the sector, and I am saying, yes, they go wider than the sector but they are also common across the

sector.

So I think now you seem to be saying that some of these costs are sort of firm-specific rather than sector-wide and that is not what I am saying, no.

Q. Well, something like the PPI for beef costs would be a very specific cost for a restaurant, would it not, that serves burgers or steaks?

A. Yes, but the PPIs I am using are not that narrow. They are much wider than that. They are designed to correspond as closely as possible with the CPI, so therefore they are designed to be sector-wide PPIs rather than firm-specific PPIs.

Q. But that PPI would measure a change in the price of beef that would be relevant only to those restaurants that serve beef and not to chicken restaurants that only serve chicken?

A. Yes, but it measuring an average of beef and chicken and everything else.

Q. Now, if the position is that on average your figures are going to go even higher, you would accept that that would be implausible, would you not?

A. Well, I do not accept that they would be even higher, no.

Q. You would not accept that they would be?

A. No.

Q. Well, if they would not be even higher, then you cannot identify any particular problem with using firm-specific costs, can you?
A. Well, you seem to be saying that the public sector data I am using is firm-specific costs, and I am saying, no, it is not, it is sector-wide costs.
Q. In any case, let us go back to the reasons you say you prefer public data analysis wherever possible. Reason 2(b), as I have termed it, is at paragraph 275(b) in your thirteenth report {RC-F/10/86-87}.
As I understand this reason, you are essentially saying it is not clear whether the data would be representative for the entire sector. Is that right?
A. Yes.
Q. But of course you have accepted the merchant data as being sufficiently representative for those sectors where you have in fact relied upon it to fill gaps?
A. Yes. Well, in some ways what you are saying is you are saying where I consider it to be representative, I consider it representative. So obviously there are some sectors where I thought it was not sufficiently representative, so I have not used data from that merchant. In the cases where I have used the data from the merchant, I have looked to see how representative it is, and I have concluded, well, it is sufficiently

representative that this can be used as an estimate for this sector.

Q. But your thought process was at no stage: I am worried this is not representative, the other figures are not reliable, I simply cannot reach a conclusion on pass-on here, and therefore I cannot establish that pass-on has been established for this sector?

A. Well, for some merchants I took the view, I said: this data clearly is not going to be representative so I am not going to analyse it. For other merchants I took the view: well, this data, maybe it is representative, and so therefore I will analyse it.

Q. It is a very straightforward question: representative or not for the ones you have relied upon?

A. Yes, well, as I discuss in the report, I consider it to be -- well, I think what I say is sufficiently representative that it provides a reliable estimate for the sector.

Q. Now, your third reason, see paragraph 3.77, which is at page 87 {RC-F/10/87}, is proportionality. Is that right?

A. Yes.

Q. Now, how does this work? Were you willing to conduct the analysis but were you told it was too expensive to do so?

A. Well, there was an issue of time here, in the sense that there was not much time between the provision of some of this data --
Q. You have a large staff at Compass Lexecon, have you not?
A. Yes. I suppose your question is you are saying did I --
Q. Forgive me -- you produced nearly 1,000 pages of material in your two reports?
A. Yes.
Q. That takes quite a lot of time.
A. Yes.
Q. Are you saying time was not available to you to carry out some sort of regression analysis on the merchant data?
A. Well, I think where your question is going is you are saying did I have unlimited resources that I could have thrown at this problem in order to produce a report, and the answer to that is, no, I did not have unlimited resources.
Q. So was it a budgetary consideration that you would not carry out the further work?
A. Yes, budget was a consideration. Yes, I obviously had a budget that I had to stay within for this work.
Q. Did you produce any preliminary estimates of the pass-on based on your analysis of merchants that did not find their way into your reports?

A. No.
Q. Now, can we then look, please, at the merchant analysis you did carry out. Of the five you chose to analyse, two were in fact dropped from the selection process before any qualitative evidence was provided. That is Pendragon and Pets at Home. Why did you choose to pursue their data, which was perceived by the joint experts not to be a necessary dataset, thus depriving yourself of the qualitative evidence that would have gone with the data?
A. Well, so I used them because they -- as I explained yesterday, there was some sectors where I did not have public data covering the whole sector, and therefore I used merchant data in those cases to fill the gap.
Q. So you considered you could analyse their data without any qualitative context. Is that right?
A. Yes.
Q. That was because you were focusing on the long-term treatment of costs rather than how they dealt with pricing on an individual basis?
A. Yes.
Q. So you did not, for example, look to see how they did or did not directly factor costs into their pricing processes?
A. No.

Q. Now, you have run a regression analysis to estimate the pass-through of total costs on prices. What were the total costs for the merchants and where did you find them?
A. So, well, the total costs were the -- I am not really quite sure I understand the question.
Obviously I was provided with data from the merchants, and that data provided information on their costs, there were different categories of costs, and so essentially I, you know, added up the different categories of costs to produce a total cost. As we previously discussed, some of these costs were directly attributed to particular products, and some of the costs were overheads that were not directly attributed and therefore I had to allocate those costs to individual products.
Q. That is the process you went through in detail with Mr Cook; correct?
A. Yes.
Q. I am not proposing to go through that again. What I would like to do is just pick out some points about individual SSH Claimants and see your responses, and possibly deal quickly with Primark.
So in terms of Pendragon, are you aware that Pendragon treats merchant service charges as an indirect

cost -- I am sorry, I am being pointed out that is confidential.

Let us wind back time, if we may. I do not think it is terribly confidential that it treats it as an indirect cost, and it certainly is not now.

Let me see if can deal with this -- yes, I can probably deal with this without going into closed session, if I am more careful than I have been.

THE CHAIRMAN: Yes.

MR BEAL: Are you aware of how Pendragon treats its costs in abstract?

A. In abstract?

Q. "Yes" or "no"?

A. Yes.

Q. Mr Cook asked you about the issues in the way that you have allocated overheads to particular products in the Pendragon data. Are you familiar with that and remember that?

A. Yes.

Q. That was based on the product share of COGS; correct?

A. Yes.

Q. I am not proposing to go over that again.

But in the end, you have produced pass-on estimates for three different Pendragon business segments, have you not?

A. Yes.
Q. One is workshop sales, another is part sales, and then you combine those to produce an estimate of 49.1% pass-on for vehicle services sub-sector generally; correct?
A. Yes.
Q. You then combine that estimate with the estimate based on -- you combine the Pendragon data estimate with an estimate based on public data?
A. Yes.
Q. The public data estimate is 111.3%?
A. Yes.
Q. So you produce a mid-point of 80.2% as your estimated pass-on rate for the vehicle services sub-sector?
A. Yes.
Q. There is a huge gulf, is there not, between the figure produced on the Pendragon data, 49%, and the estimate based on public data of 111%?
A. Yes.
Q. Did that give you the cause for concern?
A. Well, it gave me cause to think about what might be possible reasons for that. We have already gone over some reasons why I might expect the estimate from merchant data to be lower than public data. Another factor is that using the data from Pendragon, it is

a much shorter period than the public data, so maybe it is focusing more on a short-run effect, rather than a long-run effect.

Q. Pausing there. Mr Cook went through that with you, did he not, that is {Day10/53-58}, and he said if you extend the period of analysis, it makes very little difference; correct?

A. Yes, but it is still a shorter period than is captured by the public data.

Q. Were there any factors you rely upon to justify this very big discrepancy?

A. Well, I am not saying I relied on factors to justify the difference. I am saying I looked to think about factors that might explain the difference, and those are the factors that I thought might explain the difference.

Q. This is a cause of concern not just for Pendragon but for the sector as a whole, is it not, because you are relying on these figures to feed into the figure for the sector as a whole?

A. Yes.

Q. What you have done essentially is take a simple average of two inconsistent estimates and put that forward as a reliable figure on which the Tribunal can conclude that that is the answer for this sector?

A. Well, I took the two pieces of evidence that I had.

I had no particular reason to weight them in any particular way, so I just took the simple average of the two.
Q. Looking at Pets at Home, you estimate total cost pass-on by Pets at Home to be 66.2%; correct?
A. Yes.
Q. You estimate the pass-on for the jewellers sub-sector is 108.7%.
A. Yes.
Q. Again, you have applied a simple average to those two estimates to give a figure of 87.5%?
A. Yes.
Q. That is then applied to all but one of the other subsectors in your other retail sector?
A. Yes.
Q. The exception is cosmetic stores where you have deviated to Mr Holt's preferred estimate?
A. Yes.
Q. So you have considered that the Pets at Home estimate of 40-plus % is too low for the jewellery sub-sector, correct?
A. Yes.
Q. The jewellers sub-sector estimate of over 40% is too high for the pet shop sector; correct?
A. Yes.

Q. But nonetheless, you have averaged the two to come up with one figure to apply to each of them?
A. I have come -- I have averaged the two to come up with a figure to apply to the remaining sectors within the other retail sector.
Q. There are 25 sub-sectors in your other retail sector, are there not?
A. Yes.
Q. Including, for example, medical goods, chemists, tobacconists, florists, pawn shops?
A. Yes. Well, maybe just to wind back, and unfortunately this is going over what was discussed yesterday, but I did look at an alternative, which was to triangulate from other retail sectors, and looked at what estimate I would get if I used the data from those estimates, and that produced a higher number. The average of Pets at Home and jewellers was a lower number and I used the lower number.
Q. Well, if you are using a triangulation of figures from a totally different sector, with all of the subsectors that go with that other sector, why do you think that is going to be a better proxy than the ones you have landed on from the sub-sectors within the sector you are actually concerned about?
A. Well, I am testing to see what happens if you use that

other approach. I mean, I think the point that we are all agreed on is that other retail, there is a wide range of different subsectors. It is sort of the residual sector of everything that is left. Therefore it might, given it is a mix of lots of different retail outlets, it may well be that taking an average across other retail sectors might be informative, so that is why I looked at that as a cross-check.

Q. But you are highly unlikely, are you not, to be able to identify a specific accurate estimate for any given sub-sector using this approach?

A. Yes, but what I am -- well, you are correct to say that for these different sub-sectors you might expect that maybe the pass-on rate will vary across those different sub-sectors, but of course what I am trying to capture ultimately is an average.

Q. Well, you appreciate that from my clients' perspective, they do not really care about the average, they care about the rate that is attributed to them?

A. I completely understand that, Mr Beal, but obviously what you understand is that I was instructed to estimate the average.

Q. It could be, for example, that your estimates from one sub-sector to another are substantially off; correct?

A. Yes.

Q. Turning to Primark. The clothing sector is a sector where you claim publicly available data and previous studies are insufficient to quantify a pass-on; correct?
A. Yes.
Q. So the only thing -- only game in town is the Primark data?
A. Yes.
Q. Now, the papers in the literature estimate a range of pass-through of between 31 and 100%. Can we make that good, please, by looking at {RC-F/10/270}. This is your thirteenth report, please. We have there the table of the more useful studies.
You will see that it is the first one, Poterba, from 1996, that looks at a time period from 1925 to 1939, and then 1947 to 1977, that produces a full absolute pass-on of 100% of retail sales tax in the post-war period as compared to two-thirds in the Great Depression in the United States.
That is the only paper with a pass-on of 100%, is it not?
A. Yes.
Q. In that section. The others are significantly lower?
A. Yes. Well, obviously in practice we only have two papers that estimate --
Q. The other is considerably lower?

A. The other, which is from Brazil, estimates something which is much lower, yes.

Q. The Primark analysis is the only analysis you therefore rely on for your pass-on estimate?

A. Yes.

Q. You have looked at publicly available data, though, and as I understand it, you have looked at price indices, but you then conclude that those price indices analysis is not sufficient either; correct?

A. Well, what I looked at -- well, there are two points here. First of all, there is the imports issue. So imports are very significant in this sector. The PPI for imports starts relatively late, so that is one issue.

The other issue is that there are issues with the RPI and the CPI in this sector. So these, for example, were highlighted by Mr Ramirez, the expert for Primark, and have been discussed by the ONS itself, that there are -- essentially the issue is that products in this sector change very quickly. So typically a product -- fashions change. So typically a product might actually only be in the shop for a year. So if somebody from the ONS is going to measure the price of a particular individual product, that product is there one year, it is not there the next, and therefore they have to use a different product to make the comparison, and that creates issues with this index.

Q. Why is that explanation not equally applicable to other sectors which have a widely differentiated product class?

A. It is to do with the turnover of products, that products just are -- the same product is not available from year to year in the way that it is in, say, a supermarket. Obviously there are some products that are introduced and some that are withdrawn, but lots of products in the supermarket are there from year to year to year. In the case of clothes retailing, the exact specific product might -- frequently disappears and is replaced by another product.

Q. Well, Mr Holt, as I understand it, excluded some of the data from Holland & Barrett on the basis that the shelf-life was too short.

A. Yes.

Q. So you end up with skewed statistics, do you not, if you start messing around with the product mix?

A. Yes. I am not really quite sure what point you are making here.

Q. Do not worry about what point I am making, I am just trying to ask you a question and get an answer.

Can we look at the second reason you have given in

your evidence for why you have decided not to use public data in this case. That is at {RC-F/10/274}, paragraph 4.427 of your thirteenth report. As I understand it, what you are saying there is that you can only use data for 79 periods -- there are only 79 observations on the public data. Is that right?
A. Yes.
Q. But for the travel sector, you performed an analysis of public data with only 76 observations. Could we look, please, at {RC-F/10/239}, Table 65. At the bottom right-hand corner, sample period, number of observations, 76; correct?
A. Yes.
Q. So why is 76 enough for one but not enough for the other?
A. Well, the difference is that this is quarterly data over a longer period of time, so it is roughly the same numbers of observations but it covers a longer period of time, so that is the difference.
Q. Are you aware that Dr Trento modified your Primark model to look at total overheads pass-on, which produced results ranging from 18% to 31%, which was significantly higher than his estimates of 5%? That is Trento 2 at paragraph 10.82 but we do not need to turn it up.
A. Yes.

Q. So that would suggest, would it not, that your approach has skewed pass-on of total overheads estimates upwards, at least compared to Dr Trento's?
A. It suggests that we are -- it suggests that my estimate -- that my model, using that cost input, produces a higher estimate than his does, but it does not necessarily suggest that his is right or mine is wrong.
Q. Well, he has used a substantially larger number of observations than you have, has he not?
A. Yes, but the problem is that he has looked at it at the product level, and then that comes back to the point I was just making, about the fact that products have a relatively short shelf-life in this industry, and that is why I have instead looked at it at a slightly higher level of aggregation at the subsection level.
    So rather than looking at the price of, you know, an individual shirt that is only on sale for 12 months, I have looked at a category of whatever it is, men's white shirts or something like that, where you capture a longer series of time, in the sense that one particular type of men's white shirt is replaced by another type of men's white shirt.
Q. Can we move on to look at Three, and I want to take you briefly, please, to some evidence that is, I think, not

marked as confidential. So that is {RC-H1/18/3}. This should be within the witness statement of Mr Barnett, his first witness statement. Could you look, please, the paragraph 15.

His evidence was:

"... recent increase in the merchant service charge and the subsequent rise in our payment services charges still translate into a very small amount when viewed on a per transaction basis, and relative to the magnitude of costs ... Therefore, they have simply been absorbed into the financial operations team's wider budget during its re-forecasting process."

We see, paragraph 25, page 5 {RC-H1/18/5}:

"... rather than prompting a price-change as against our competitors, any small changes in costs are much more likely to be absorbed by the business."

Can you see that?

A. Yes.

Q. Your approach to dealing with Three's data was to take, as the independent variable aggregate, monthly total costs per user. Is that right?

A. Yes.

Q. As the dependent variable, you took aggregate monthly total revenue per user?

A. Yes.

Q. So in each case, that is just total monthly costs and revenue respectively divided by the number of users?
A. Yes.
Q. That would create one data point for costs and revenue each month?
A. Yes.
Q. So that produces, does it not, 72 months of 72 data points based on the data you had?
A. Yes.
Q. Now, Three provided much more granular data, did it not, at the level of each individual contract?
A. Yes.
Q. So Dr Trento's model was built on approximately 22 million data points at that level. Would you accept that?
A. Yes.
Q. That is going to produce a much more compelling analysis, is it not, than your highly aggregated approach to the data?
A. The reason I used -- had to use a more aggregated approach was because I was looking at total costs, and therefore I had to allocate the overhead costs, and the overhead costs were only available at that frequency.
Q. Dr Trento modified your model to look at the pass-on of total overheads. Are you familiar with that?

A. Yes.
Q. When he applied your two total overheads, your preferred model specification, he produced results showing that total overheads pass-on estimate would be 21%. Are you familiar with that?
A. Yes.
Q. So that suggests that even using your aggregated approach, you still get a much lower pass-on rate than the one that you are urging -- or encouraging the Tribunal to follow?
A. Yes.
Q. On WorldRemit, you analysed WorldRemit data and came up with an estimate of 36% based on an average total cost. Is that correct?
A. Yes.
Q. There was no qualitative data from WorldRemit, was there, in terms of witness statements or anything else?
A. No.
Q. So we do not know whether WorldRemit factored certain costs directly into prices or not, and we do not know which buckets the MSC fell into; correct?
A. Correct.
Q. The average total costs figure will necessarily include the MSC itself, will they not?
A. Yes.

Q. Does that not create the very endogeneity problem that we have identified would inflate the pass-on rate in other cases?
A. Well, the MSC is obviously a very small proportion of that total cost. So to the extent that there is any endogeneity, you would expect it to be very small. I cannot remember which merchant it was, but for at least one of the merchants I tested what happened if you took the MSC out of the costs, and it did not change the estimate materially.
Q. So you are not worried about a problem with endogeneity because the MSC is so small, but you are nonetheless, for your overall analysis, saying that the MSC is sufficiently important that it is going to move the dial on pricing on an inferential basis?
A. Yes.
MR BEAL: Thank you. I do not have any further questions.
MS BOYD: No questions from me.

Re-examination by MR WILLIAMS

MR WILLIAMS: I have one very brief transcript clarification question, and it is almost Christmas, Mr Coombs.

Could we turn, please, to yesterday's transcript and to page 77, please. Right at the bottom, at line 24, you will see the beginning of Mr Cook's questions to you, this is in the other retail sector and he says:

"Question: 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?"

Then you will see your answer:

"Well, it is --"

You broke off after the "it is", or the transcript did not quite capture what you said, if anything. I just wanted to check, Mr Coombs, whether or not you were accepting that your figure of 88% for the other retail sector is a fantasy?

A. No, I was not, no.

MR WILLIAMS: Thank you very much.

Questions by THE TRIBUNAL

THE CHAIRMAN: I just have one question about your 91% pass-on rate economy-wide, which is what you say would happen in the long-run, that there would be a 91% pass-on rate?

A. Yes.

THE CHAIRMAN: Is that right?

A. Yes.

THE CHAIRMAN: Based on the economic incentives that are around, you say that all costs will essentially be

recovered in the long-run. But 91% assumes that 9% are not recovered through increases in prices, is that right?
A. Yes. So I can perhaps -- I can see where you are going with this, sir. I think the point is that that assumption or that conclusion that everything will be passed on assumes that you are dealing with a highly competitive market where there is no scope for anybody to absorb any of the cost increase in their margins. Now, it may be that, in practice, these markets are not actually that competitive, and therefore there might be some degree of market power that some firms have that means that they can, to some extent, absorb some of the increase. So that would then indicate that you would have a slightly lower than 100% pass-on rate.
THE CHAIRMAN: Right. So effectively the costs are being recovered through some other route?
A. Yes.
THE CHAIRMAN: Is that right?
A. Yes. Well, it could -- well, so two possibilities. One is that they simply are not being recovered, that they are resulting in lower profits. Another is maybe to some extent they are being recovered from suppliers, or in some way that -- some firms find some way to reduce their costs. So, you know, previously I said, well, if

a firm is in a perfectly competitive market, you would expect that it would have no scope to reduce its costs because it should already be operating at maximum efficiency, but if firms are operating in a market where they have some degree of market power, then they might not be operating at maximum efficiency, and therefore there might be some scope for them in reaction to a cost increase to try and reduce costs in other areas, where currently they are operating a bit inefficiently.

THE CHAIRMAN: Yes, so I understand that. So if -- so how do we know that the MIF, an increase in MIF is in the 91% or the 9%?

A. I think the point is that what the 91% is saying is it is saying that in response to an increase in cost, the firm will increase its prices by 91%, and then the 9% will be either recovered through finding cost savings somewhere, or through accepting a lower profit margin. So what I am not saying -- I am not saying that, you know --

THE CHAIRMAN: You are looking at the total costs?

A. Yes. I am not saying that 91% of cost increases are passed through at 100%, and 9% are passed through at 0%, never passed through. I am saying on average they are all passed through at 91%, and the remaining 9% of the cost increase is either absorbed as a lower margin, or through reducing costs somewhere else, or most likely a combination of the two.

THE CHAIRMAN: So the MIF element of that total cost, where you come up with the estimate, how do we know that that element has been passed on into prices, rather than being absorbed or whatever?

A. Yes, I am --

THE CHAIRMAN: We cannot, can we?

A. Yes, I am not -- so I am not trying to distinguish and say some costs are passed on at this pass-on rate and others at another pass-on rate, all I am doing is I am saying this is the average across all cost increases.

THE CHAIRMAN: All right.

Well, I think that is it. Apparently it is Christmas time for you.

THE WITNESS: Thank you.

THE CHAIRMAN: Not for us. But thank you very much, Mr Coombs. You are free to go.

THE WITNESS: Thank you.

(The witness withdrew)

MR DRAPER: With the Tribunal's permission, sir, we will call Mr Greg Harman.

THE CHAIRMAN: Absolutely.

MR GREG HARMAN (affirmed)

Examination-in-chief by MR DRAPER

THE CHAIRMAN: Thank you, Mr Harman. Please sit down.
MR DRAPER: Mr Harman, you should have in front of you a file with two documents in it.
A. Yes.
Q. Can you please turn to the first of those documents {RC-F/13/1}. Do you see there a report in your name, dated 8 August?
A. I do.
Q. Could you turn to page 155, please, {RC-F/13/155}.
A. Yes.
Q. Do you see there an expert declaration?
A. I do.
Q. Over the page, a statement of truth {RC-F/13/156}?
A. Correct.
Q. Are there any corrections you wish to make to this document, Mr Harman?
A. Not that I am aware of.
Q. Below the statement of truth and declaration, there is a signature. Is that your signature?
A. Yes.
Q. Is the statement true to the best of your information and belief?
A. It is.
Q. Could you turn now, please, to the second document {RC-G/11/1}. You should see there a reply report in

your name, dated 9 October. Do you have that?
A. I do.
Q. Could you please turn to page 201 {RC-G/11/201}.
A. Yes.
Q. Do you have there an expert declaration, and then over the page a statement of truth?
A. Yes, that is correct.
Q. Are there any corrections that you wish to make to this document?
A. Again, not to my knowledge.
Q. Is the signature seen there your signature?
A. It is.
Q. Is the statement true to the best of your information and belief?
MR DRAPER: Thank you, Mr Harman. Counsel for the other parties will have some questions for you.

Cross-examination by MR BEAL

MR BEAL: Good afternoon, Mr Harman. Could I give you the usual disclaimer, which is that I am afraid I do not have time to go through every point which may be an issue between us, and the fact that I do not cover something does not mean that it is accepted.
A. Okay.
Q. In your 2015 report for Mastercard in the *Sainsbury's* proceedings, perhaps we can bring that up {RC-K/3/26},

paragraph 2.11.
A. Yes.
Q. You are giving evidence on behalf of Mastercard as to overcharge and you conclude that:
"SSL [*Sainsbury's*], is likely to have passed on any MIF overcharge to customers because ..."
Then you cite the British Retail Consortium claim that retailers generally recover interchange fees through prices charged to consumers, hence any MIF overcharge would likely be passed on to consumers. Can you see that?
A. I can.
Q. In particular, then, please, at page 66 of {RC-K/3/66}, paragraph 7.13, you cite expressly from the BRC complaint. Is that fair?
A. Can I just read it?
Q. Yes, of course. (Pause)
A. Yes, that is -- I am quoting the BRC.
Q. I want to put to you a characterisation of the BRC as an organisation and see whether or not you agree with it. So the characterisation would go along the lines that this is a pressure group making unevidenced assertions designed to pressure -- persuade a regulator to limit MIFs, and so not much value can be placed on its opinion. Do you agree with that as a characterisation?

A. Well, I do not know if that is the characterisation that people have. It is not one that I have personally. What I took from this evidence, amongst other pieces of evidence, was here is a body suggesting that the MSC will be passed on. There was other evidence, obviously, that brought -- I brought together a factual matrix and made a conclusion, none of it rested on this particular point within this, I believe, that Tesco itself, Mr Mourant, also gave evidence as to what he thought Tesco would do in the circumstances, just as an example.

Q. Could we look, please, at Mr Coombs' thirteenth report {RC-F/10/44}, paragraph 2.52(b).

You will see that Mr Coombs has relied upon the British Retail Consortium's formal complaint to the OFT in which it said:

"Merchants are not simply able to absorb the high cost of interchange ... This inevitably has led to higher prices generally."

That is the same quote that you have relied upon, is that right?

A. That was -- I mean, that is one of the quotes that I relied on, yes.

Q. Could we then turn in the transcript, please, to {Day9/68:23}. Would you read, please, the question:

"Question: So what they are doing in any event is talking about, say, the high street retail, not the wider sectors you are looking at. But basically you have pressure groups, retail and pressure groups, making unevidenced assertions designed to persuade regulators to limit interchange fees."

Can you see that?

A. I see the question.

THE CHAIRMAN: This is Mr Coombs' evidence?

MR BEAL: This is Mr Coombs' evidence. So this was a question that was put to Mr Coombs by Mastercard's counsel, Mr Cook KC, in which he is suggesting that no reliance can be placed on what the BRC has said, because it is, and I quote:

"... a pressure group making unevidenced assertions designed to persuade regulators to limit interchange fees."

So my question to you is: do you accept that characterisation and the limit that should be placed on the BRC evidence, as Mr Cook suggests, or do you stick by the evidence you gave in the *Sainsbury's* proceedings?

A. Well, I am just looking at the answer that Mr Coombs actually gave, and I think that accords with the view that I took once I was in *Sainsbury's*. I do not have any -- I do not have any evidence that what was being said was factually untrue. It may be the case that they are a public body trying to place pressure on change, but at the same time my plain reading of that document is one that suggests that the retail industry would see MSCs as a cost that would be passed on. I think there is currently a similar BRC statement in relation to Labour's National Insurance increases and increases in minimum wage.

As I said, we at the time looked at a factual matrix of evidence that was pointing in the same direction. Obviously it is for the Tribunal to make its decision as to what weight it should place on this type of evidence.

Q. Can we look at your first report, please {RC-F/13/6}, paragraph 1.2.4.
A. Could you say it again, sorry?
Q. The first report, paragraph 1.2.4, page 6.
A. 1.2.4.
Q. Page 6.
A. Yes.
Q. You say there that the MSC is negotiated between the acquirer and the merchant. Can you see that?
A. Yes. I mean, that is a summary that I am giving from other documents.
Q. You were not present in Trial 1, were you?
A. No, I was not.
Q. Are you familiar with the evidence that was given in

Trial 1?

A. No, I am not. I mean, as I say at the beginning, this background is not meant to be contentious. I am taking it from somebody's -- well, actually from various legal documents. It does not actually necessarily impact any of the conclusions in my report. It is just meant to be background and summary.

Q. So to the extent that the evidence in Trial 1 was to the effect that nobody can negotiate the multilateral interchange fee, it was simply presented on a "take it or leave it" basis for card usage, you would not be able to -- you are not seeking to go behind that in any way?

A. I am not seeking to go behind that. I do not think my evidence is that they should try and seek to negotiate. I see some evidence in the factual record that they have tried to, but that is not something that I rely on.

Q. Similarly, in paragraph 1.2.5, you say Mastercard is only involved in payments between issuing banks and acquiring banks where Mastercard is contracted to provide clearing services. Again, you are not seeking to go behind the evidence that was presented in Trial 1 on that issue, are you?

A. No, I am not. You can see that I have referenced Hilton's defence on that matter.

Q. More generally, the expert work in this case was

bifurcated between you and Ms Webster, that is right, is it not?
A. Yes. I mean, I would say, yes, to the extent that I was asked to look at the factual record from an accounting perspective, and Ms Webster relies on certain of my findings in her evidence, amongst other inputs into her analysis.
Q. You do not cover economic literature or econometric analysis?
A. I do not. Save for the fact that in my second report I was asked to look at the cost proxies, but I was doing so not from an econometric point of view.
Q. You had not been asked to look at that in your first report, had you?
A. That is true.
Q. Presumably you are not saying it is beyond your competence to look at these issues?
A. I do not think it is beyond my competence.
Q. Now, in your first report, please, paragraph 3.2.4 {RC-F/13/28}, this is you citing from the Supreme Court judgment in *Sainsbury's*, trying to identify the key issue, is that right?
A. Yes.
Q. That issue is whether there is evidence to establish that merchants have either sought to reduce costs by

renegotiating terms with other suppliers or passed on the cost of the overcharge by increasing the prices they charge to their customers. That is essentially category 3 and category 4 of the Supreme Court's four-fold classification?
A. I am quoting the Supreme Court there, yes, but obviously my report is based on my instructions. Again, this is background information.
Q. You would recognise, would you not, that this is going to be primarily an empirical question?
A. I think that is correct, because what I say in my report, in many places, is that one of the focuses is to identify the mechanisms by which pass-on could emerge. In *Sainsbury's*, I was asked to opine on a percentage of pass-on, likely percentage, which I could do in the *Sainsbury's* case, because the factual record was much denser. The number of document available over the time period was over 40,000 documents that I had access to, so you could really pull together a very rich story.
Q. Just pausing there. You recognise that this Tribunal did not accept or did not follow the analysis that you were urging upon them in that case?
A. Which aspect?
Q. They did not accept that there would be pass-on.
A. Well, that not quite true, because when it came to the

legal question of pass-on, they ruled as they ruled, but when they came to interest, they accepted that the profits in the counterfactual would not have been at the same size as the pass-on. So when it calculated interest, the Tribunal made a calculation for the difference between the actual and counterfactual scenarios --

Q. You are describing there the basis of the appeal that was then brought unsuccessfully by Mastercard to the Court of Appeal?

A. I think actually, if I remember rightly, and I could be wrong -- and it is not a document I have gone back to -- but as part of the evidence I provided in that first case was also a claim for interest, interest on the loss. If I remember correctly, that overall claim was reduced because they accepted that the economic financial pass-on, which may differ from the test of legal pass-on, did impact the amount of money that they had lost, and therefore the interest claim was not based on the total claimed amount but a percentage of that to recognise that factor.

Q. Now, given that it is an empirical question, you must recognise that you need to consider the evidence in support of the proposition that costs of the overcharge have been passed on by increasing the prices that

merchants charge to their customers?
A. I would -- I mean, I did not get to the end of my last question. Where we have bifurcated is that Ms Webster has done the econometric analysis, quantitative analysis, but it is well-recognised that any econometric analysis should also be framed in the factual matrix, and that is what I have provided Ms Webster, my understanding of the factual matrix, which then, to a certain extent, feeds in to her assessment.
Q. So the empirical question would be whether or not merchants have mitigated their loss by taking any specific steps to transfer the overcharge on to somebody else by way of downstream pricing, for example; correct?
A. Yes, I think that is correct.
Q. The Supreme Court made clear, did it not, that one response from a merchant was not to take any specific steps but simply to take it on the chin and suffer a corresponding reduction in its profits?
A. Yes, I think that is correct. I think that is consistent with the economic theory that pass-on can be between 50 and 100%. So, I mean, I think --
Q. If you are looking for an identifiable act of mitigation, and you are saying that what the merchant firm has actually does is simply take it on the chin and accept it will have lower margins and it has borne the

cost itself, that cannot conceivably be passed on at 50%, can it, because they have not taken any steps to mitigate that loss?
A. No, it is the other 50% that has been mitigated.
Q. How so? If they have taken no steps whatsoever, they simply swallowed the cost, which is category 1 in the Supreme Court which they say is not pass-on. Are you saying the Supreme Court is wrong and it should have applied a 50% de facto pass-on regardless of whether it is category 1, 2, 3 or 4?
A. I think we are slightly at odds, if I understand question correctly. Is this by reference to *Sainsbury's*?
Q. This is by reference to -- you have chosen to cite the Supreme Court analysis in your report.
A. Yes.
Q. So I am asking you to consider, not category 3 or 4, which the Tribunal will understand are examples of pass-on that the Supreme Court has accepted, but categories 1 or 2 where they say these are not pass-on.
A. With -- these are the four -- as I understand what the Supreme Court is saying is that there is, in general, four responses. One response is to take it on the chin, yes, and I would agree with that, that is a potential outcome. There is also a potential outcome that they

may seek to mitigate their costs in some way or seek to pass on, so I completely agree with that.

Q. What I do not understand is your answer to my question. Hopefully one understands my question. But your answer to my question was whether that would still produce a 50% pass-on rate and I just do not understand the logic there. I am sorry if I am missing something.

THE CHAIRMAN: I think it was when you said 50 to 100% is what economic theory would say would be pass-on, but I am not sure where that came from.

A. I think the point that I was making is that would I expect there to be a potential loss? Is it possible that there could be a loss? I was referring to the high level economic theory that would say between monopoly and price competition you may not achieve pass-on, and if you did not achieve pass-on, then of course that puts you into category 1, or, sorry ...

Q. Well, why did the Supreme Court not say in category 1 and 2, your enquiry is going to be as to where it lies between 50 and 100% because, as a matter of economic theory, that is where the range is?

A. Well, I think that is because you can have instances where there is a divergence between economic theory in practice, but also it depends on whether the industry is more competitive compared to less competitive. So, you know, my point with this is that there are four responses, I acknowledge all four of those, and when I look at the factual record I seek to see where, within that matrix, that four matrix, the most likely result is to be.

Well, I do not opine obviously on the degree of pass-on. Again, I am looking at primarily the mechanism for either explicit or --

THE CHAIRMAN: But are you saying there is a minimum rate of pass-on of 50%?

A. No, no.

THE CHAIRMAN: You are not?

A. No, I am not. I am just saying that, you know, that is an economic theory.

THE CHAIRMAN: You just threw it out there, I think, 50% -- 50 to 100%, and I was not sure where that came from.

A. I said it only because one of the standard economic outcomes is that there is an expectation that pass-on will be between 50 and 100%, but there are other factors that one would have to take into account as to whether that is likely to arise. One of those factors, for example, is whether it is a specific cost of the business.

THE CHAIRMAN: Yes.

MR BEAL: Your instructions were not to deal with economic

theory and you have left that to Ms Webster?
A. I have not left it. I have been instructed for her to think about that from an econometric perspective. I think we are at common cause that to calculate the level of pass-on is an econometric analysis, a quantitative analysis.
Q. Right. Let us go back to what you are actually trying to do. In your first report, please, 3.2.6 {RC-F/13/28}. Further down the page we are looking at. As I understand it, you have separated your analysis into two separate stages. First, whether or not the MSCs were explicitly included in the merchants' price-setting process. Is that right?
A. Correct.
Q. Secondly, whether MSCs were implicitly included through budgeting and performance monitoring. So those are the two channels that you are looking at, is that right?
A. Yes, that is correct.
Q. Now, the budgetary process that you are describing will not be a direct means of showing pass-on, will it?
A. The budgetary process?
Q. Yes, the budgetary process. Monitoring budgeting and performance processes will not establish a specific positive step to pass on the cost to someone else?
A. Maybe I do not quite understand the question. I mean,

with respect to budgets, I frame that as an indirect mechanism.
Q. Yes.
A. Yes.
Q. That is the point I am making.
A. Yes.
Q. If a firm typically puts all its costs into a budgetary account, an implicit mechanism would suggest pass-on in every case, would it not? If simply having it in the accounting information is enough, and all costs go into the accounting information, does it follow from your analysis it is pass-on in every case?
A. No. It would depend on a number of factors, one of them whether it is a specific cost to the firm, compared to whether it is a cost that is common across the industry. Firms that, for example, are less efficient than other firms, if they had a specific cost that increased, they would not be able to pass that on through prices.
Q. Your indirect implicit channel necessarily implies that it is not terribly immediate, does it not; it will be a longer term process?
A. Well, it could be, but it could also be within a year, because --
Q. What is the real world practical trigger for your pass-on?

A. Well, I am not estimating pass-on. I am considering whether there is a mechanism for pass-on.
Q. What is the practical trigger in your theoretical mechanism?
A. In terms of budgeting?
Q. In terms of passing the cost on. We have agreed that the empirical question is: has this cost been passed on? So I am now inviting you to say how you would help this Tribunal in identifying the specific process by which, theoretically, your pass-on will be transferred to the consumer.
A. Okay, so the indirect mechanism is that at the beginning of a financial year, a top-down target is presented to the firm from the executive -- I am talking in general terms. That leads to a set of bottom-up processes, where managers who have responsibility for developing budgets do their best efforts to think what the budget is for the year. That budget and target is then compared, and to the extent that there is a gap, the business will think about how does it bridge the gap. In the documents you see lots of these types of bridges, profitability bridges, you see cost bridges, and so on and so forth.

The process identifies that there is a financial target, and generally for businesses the financial target will be a level of profitability. Now, what matters to a firm more than anything else is what is their bottom line profit, because that is the profit that can be distributed either to equity holders or to debt holders or can be paid in bonuses.

Q. When you say it is bottom line profit that matters, if the evidence we have consistently heard from merchants, for example, is that pricing decisions are taken by reference to the gross margin, and comparing the revenue against the cost of goods sold, then the direct mechanism for pricing is necessarily involving the gross margin and not the bottom line margin, the operating margin?

A. So let me connect, refinish my answer, and answer that one at the same time.

Once the bottom end budget is set, the level of overall profitability that the firm needs to achieve, that will flow up through the requirements elsewhere, because a gross margin cannot be set in isolation of understanding what the bottom line target is. So at that point in time in the budgeting process, a firm, a general firm, has two options. One is: can it bridge the gap between the budget and the target by incentivising savings in various cost categories, it could be both in overheads and in the cost of goods sold. If there is still a gap, then what it might do is have a stretch target for the gross margin. It is the link between an end level profitability with the gross margin that creates the mechanism for pricing to be passed on.

There is a second mechanism that flows from the budgeting and that is one of monitoring. So what all of these companies do is monitor on a monthly basis costs and revenues, understanding where there is over and underperformance, on which they then need to make a consideration as to what the business is going to do. It can lead to a number of things. It can lead to a reforecast, or it can lead to the company making two types of challenge. First challenge, it may say we need to reduce costs, because we are not going to hit the bottom end target, or it might say we have to consider whether we can increase prices.

So that is the mechanism through the budgeting process.

Q. That mechanism, you say, would also apply to decreases in costs, such as the MSC?

A. Yes, I think it would.

Q. So if I give you a real world example of a price decrease in January 2016, when the IFR capped interchange fees at 0.2% for debit cards.

A. Yes.
Q. That would be a real world decrease in the MIF?
A. That would.
Q. Fed through to the MSC?
A. It would have.
Q. The MSC was therefore a reduced cost?
A. Correct.
Q. When would a company, such as Hilton, have reduced its prices in response to that real world decrease in the MIF?
A. Well, if we had the factual information at 2016, we would be able to test that. Of all of the claimants, the vast majority of them only provide information for 2023/2024. Some, between the period of 2020 and 2024, I think only one of the companies provided sufficient documents of the whole process, but the vast majority of them were end-loaded.
So I do not have access to the financial information that would allow me to test that.
Q. Well, you have access to the statutory accounts for Hilton going back to, well, since they started trading.
A. No, but I do not think the aggregated accounts at corporate level are going to tell me what the reasons for any movement in profit is likely to be. What one needs to look at --

Q. It is more than that, is it not, because unless there is a specific line item in the management accounts for the MIF, or, let us be fairer perhaps, the MSC, it is going to be treated as part of a cost of payment costs or a higher subset of costs that is an aggregated cost bucket?

A. Well, I think that, again, there is -- there is this point that, you know, if you are looking at the financial accounts, they are at a level of aggregation that is governed by the International Financial Reporting Standards and other standards in the UK. Whilst there is some subjectivity in how those standards are adopted, it does set out, if you like, a minimum template for what firms need to disclose to the readers of account, but that does not mean that that structure flows down through the company and that the company itself does not have the level of information that it could observe a change in the MSC.

So what I have not been able to obtain in evidence is the breakdown below the monthly budgets, but I would imagine -- I think it is reasonable to assume that the CFO or the financial controller or the head of management accounting would have evidence at a very disaggregated level and it would have access at a very disaggregated level, because all transactions are entered into the books of prime entry of a firm and they are at an extremely disaggregated level. So firms would be able to pull this off their financial accounting systems.

Q. Have you been through the testimony that was given by the factual witnesses two weeks ago before this Tribunal?

A. Yes.

Q. I will come back to deal with that factual evidence a bit later on, but I just wanted to check as a matter of parameters where you are.

Do you accept that, as a general principle, simple cost recovery does not establish pass-on?

A. From a legal perspective?

Q. No, from an economic perspective.

A. Well, I think that it can do.

Q. Could you please look in Mr Murgatroyd's first expert report {RC-F/6/35}, paragraph 155. What we have here is a worked example in order to deal with this distinction between cost recovery and pass-on as a concept. Could you please read that paragraph, if you are not familiar with it.

A. 155?

Q. Yes. (Pause)

A. Okay. So this is an example of the reaction of

adjusting the price for a change in cost.
Q. It is an example, is it not, of the distinction between a pure cost recovery exercise and a distinct act of pass-on?
A. Well, I think that Mr Murgatroyd here is only considering price pass-on, he is not thinking about the cost pass-on. It is something that I state in my reports quite a lot, that having identified that there is this route, Mr Murgatroyd then does not go on to say whether that is cost mitigation that would fall into supplier pass-on, and my point is that that is a potential indirect route for mitigating --
Q. Could you just read then, please, 156 as well. (Pause)
A. Yes.
Q. In contrast, in 157, the concept of pass-on refers to the extent to which a firm responds to a cost change by adjusting its own prices. So he is drawing a distinction between the two as a matter of economic principle, correct?
A. I think what he is saying there is that there is a cost change, and when he is thinking about price pass-on, he is thinking about the impact that that cost change has on prices. Whereas when we are talking about cost offsetting, we are thinking about whether one cost increases, whether a response to that is a reduction in

other costs.
MR BEAL: Can we take a break there, please.
THE CHAIRMAN: Yes.
PROFESSOR WATERSON: I just wanted to ask: when you were with Mr Beal, he said what about the cost decrease.
A. Yes.
PROFESSOR WATERSON: So the firm -- it is not necessarily a symmetric position if in this budget challenging process you say, well, there is this top-down process and then a bottom-up process and then potentially stretch targets?
A. Yes.
PROFESSOR WATERSON: If, at the bottom end, prices -- the costs have gone down, how would the process work?
A. So, for example -- sorry, I should just ask about confidentiality. Am I ...
THE CHAIRMAN: Well, we are in open session, so if you are going to disclose anything, try and avoid that.
A. I will talk generally as opposed to giving a specific example.
What you see occasionally in budgets is that there is a gap between target profit and what the budgeted profit has been, and what you see is that they put at the beginning of the year a level of unidentified savings that they are challenging the business to seek.

It is a direct challenge. It is almost like if you were in a regulated sector and you put in an RPI minus X, you are giving that company -- you get on and deal with this the best that you can.

What I would say in the counterfactual of a lower MSC, obviously when that budget, bottom-up budget gets set, that cost has reduced to zero. So the level of profitability that the budget is suggesting will increase, which leads to a reduction in the level of the unidentified saving that needs to take place. So that is the mechanism that savings in the counterfactual would be --

PROFESSOR WATERSON: Assuming there is this gap, assuming there is this stretch target?

A. Well, I think, yes, but that stretch could have already been identified in the process where the budget gets developed, which will have a number of iterations, and during those iterations, some of the unidentified gap might become identified in the process and, you know, my assumption, or what I think could happen in that situation, is that it is management that is incentivising people to make the savings, that they then target those savings at the end of the day. People only react to what they can see in front of them in terms of a level of savings.

Very much in *Sainsbury's*, for example, that is a mechanism that we saw month -- well, year in year out across the process, and when we had really detailed information we were able to check whether they were able to meet those gaps or not throughout the process, and that was one of the reasons, in *Sainsbury's*, I came to the conclusion that that direct mechanism seemed not only to be, you know, a possible mechanism, but it was very much an actual mechanism.

PROFESSOR WATERSON: Thank you.

THE CHAIRMAN: All right. We will take a ten-minute break.

(3.20 pm)

(Short Break)

(3.30 pm)

MR DRAPER: Sir, I am on my feet, with apologies to Mr Beal, to raise a short point on confidentiality.

Mr Harman has said once already that he would like to give an example, but he is obviously constrained somewhat whilst we are in open session.

THE CHAIRMAN: Yes.

MR DRAPER: I just raise a concern about that, because it is just in the nature of Mr Harman's evidence that what he does is to go through confidential material, so it might be quite difficult for him to answer many questions in open session.

THE CHAIRMAN: Were you proposing to have a closed session, Mr Beal?
MR BEAL: Yes, and it is likely to be --
THE CHAIRMAN: This afternoon?
MR BEAL: No, tomorrow morning. What I am trying to do is deal with all the things I can deal with in open and then go into closed tomorrow morning.
THE CHAIRMAN: Okay.
MR BEAL: By all means --
THE CHAIRMAN: Well, yes.
MR BEAL: -- we can recircle back to this point so that Mr Harman can, unimpeded, make the point he wished to make by reference to the individual claimant.
THE CHAIRMAN: Yes. I think we should try and have as much as possible in open court, so if we could try and avoid anything confidential for the rest of this afternoon, and then we will have a closed session tomorrow.
A. I think I can talk in general terms.
THE CHAIRMAN: Yes. If there is something confidential that you want to refer to, then maybe you can say that and we will come back to it tomorrow.
MR BEAL: I am sure Mr Draper will come up with a shopping list for me tomorrow to come back to.
THE CHAIRMAN: Yes.
MR BEAL: Now, Mr Harman, please can we look at

{RC-F/13/28}, your first report, paragraph 3.2.7.
A. Yes.
Q. You say here you are looking at whether a merchant is likely to have responded in a certain way; correct?
A. Let me read the paragraph. (Pause)
Q. It is in the first sentence.
A. Yes.
Q. That is because you are not able to show, are you, that merchants did in fact respond in a particular way?
A. Can you clarify the question?
Q. Well, the question is: you are switching the analysis to whether or not merchants are likely to have responded in a certain way because you are simply not able to show that merchants did in fact respond in a certain way?
A. That is correct. As I explained, on prior cases I had significantly more information to be able to bring together the factual matrix, so the primary purpose of my report is to identify the mechanisms and how certain costs are treated, and that is input into Ms Webster's analysis.
Q. In your second report you give yourself another task. Can we look there, please, at {RC-G/11/7}, paragraph 2.1.3. You say you propose to respond to the other experts' interpretation of the qualitative evidence --

A. Sorry, could you just ...
Q. 2.1.3.
A. Okay. (Pause)
All of the claimants' experts provided various levels of assessment of the qualitative material.
Q. So you are saying whether or not a witness is right or wrong to have said what they said, as I understand it?
A. Well, I was just -- what I seek to do is to the extent that they have, for example, quoted something from a witness statement, often I say that that is a fair representation of obviously what is said in the witness statement, and I am not saying that anything in the witness statements are incorrect, but on occasion I say: but there is something in the factual matrix that has not been commented on, and make a point as to whether I think that it changes my opinion or not. Again, we can go through specific examples of that, but it would be at a --
Q. (Overspeaking) You would accept it is not your place to comment specifically on factual issues as an expert?
A. Well, I think that it is relevant for an accountant, an economist, to base their assessment on the facts, and through experience I can give my interpretation of it. I am not suggesting for a second that the Tribunal will not come to their own conclusions. All of my

conclusions are based on facts that I see, and hopefully that will assist the Tribunal in interpreting what both parties have said.
Q. But you would not be saying: Mr X says Y and Mr X is wrong to say Y?
A. Well, for example --
THE CHAIRMAN: Can you just answer the question.
A. Well, I was going to by an example, but I think it depends on what point is being made. So, for example, if somebody said -- if it was said, for example, there is -- or what they have relied on, on a witness statement, for example, and said the claimant would not seek to reduce costs if another cost increased, if I found evidence where I actually see that happening I point that out. Often I do not have lots of examples because the data is relatively little, and in some cases I say, well, there is not sufficient information for meet to be able to make a conclusion, because there is just not enough of it.

So I am trying to use the factual evidence that I see in the record at a more detailed level than the witness statements to see how the business is trying to operate.
MR BEAL: Now, to summarise, essentially the way you are seeing the implicit channel for pass-on is because

businesses carry out their usual monitoring and review functions of looking at the revenue and costs of the business. They operate a normal budgetary process, and you say through that mechanism you can infer that there has been pass-on of any MIF overcharge; correct?
A. Well, that is -- again, I go back to say that my primary evidence is that there is a mechanism, and the percentage of pass-on or the degree of pass-on is what Ms Webster looks at. The factual record is not significantly dense enough for me to be able to make opinions on what the likely rate of pass-on is, and that is something that I have said in my report on numerous occasions.
Q. You have not highlighted any specific pricing decisions that are causally connected to the overcharge?
A. I have not. Again, that is a factor of potentially data, and the fact that I have very little data around 2016 where there was a change in MSCs, and therefore, for the rest of the period that I have data for, I do not have that specific cost shock or experiment to consider what happened.
Q. You have not considered the extent to which prices did in fact fall when the IFR caps came into place?
A. I have not, because I do not have the information over that period due to the disclosure.

Q. If prices did not in fact fall to any material extent, that would suggest there was no causal relationship between MSC costs and prices charged to customers; correct?

A. Well, there could obviously be a delay, but if you are saying that there was no evidence in the record that a change in the MSC led to a change in price, if that was factual evidence that was available, that may be compelling for the Tribunal, but I have not seen that in the factual record.

Q. We do have some factual evidence because I took Mr Coombs to it, and that was in the form of Mr Ramirez's second report, his positive case, where he looks at the distinction between a VAT decrease for Primark and a response to the IFR changes in 2015.

If you give me a moment, this is in my other -- I have already asked this question to Mr Coombs. I am just trying to find my note which deals with this. Bear with me a moment. (Pause)

Thank you. Could we please go to {RC-F/8/26}, paragraph 56.

A. Yes.

Q. We have Mr Ramirez giving an example of a varied reaction to an increase in cost common to mass market apparel retailers, being the 2011 VAT increase. Can you see that? Perhaps if you read that paragraph to yourself.

A. Thank you. (Pause)

Okay, so this is a change in the VAT in 2011 versus --

Q. Well, we then move on, please, to page 81 of this document {RC-F/8/81}, paragraph 217.

A. Yes.

Q. In Chart 11 that we have there, we see how prices have generally -- the percentage that prices have changed as correlated with a VAT decrease in 2008, compared with the change in prices as a percentage of products following both Visa's CAR concession and then, separately, the IFR implementation.

So it is not right to say we do not have anything in the evidential record; we have this example of Primark responding quite clearly to a VAT decrease and not responding to the slashing of MIF rates with the IFR.

THE CHAIRMAN: I think it was a VAT increase, was it not?

MR BEAL: Sorry, VAT increase. Yes, I apologise.

A. I do not think that I know enough about the calculation here to be able to comment on the degree of its accuracy. That is not something that I have looked at. If you were able to give me a bit more information on it, I might be able to assist.

Q. So the first -- I should point out, I think I answered incorrectly to the learned Chairman's question. The 2011 VAT increase, they were looking at the differential response by M&S and Primark. That was the first paragraph. This paragraph, Mr Ramirez is in fact dealing with the VAT decrease in 2008 and contrasting that with a decrease in MIF rates in 2015. That is essentially what is being done. To make that good, you can read paragraph 217, just below the chart.

A. Okay. (Pause)

Yes, I mean, I think the problem with this --

Q. Just before you give an explanation: had you read this before you are giving your testimony today?

A. I mean, I read Mr Ramirez's reports over the duration, yes.

Q. Sorry, you were about to say something. I did not mean to interrupt.

A. Yes, I think that the problem with this type of analysis is that it is looking at whether you observe a price changing, given a change in one cost. But what the analysis is not doing is what was happening with all other costs at the same time. A price response is going to be based on total costs. So if one cost falls, in this case the IFR, but another cost offsets that, then you would see a smaller change in prices, and now when

I have read paragraph 217, it does not suggest that it is controlling for all other costs that are happening. You would need to do that because a change in VAT is quite significant, and so you are likely to see an impact, but if the change in MSC is smaller, which it definitely was for the IFR, then controlling for other cost changes at the same time would be vitally important.
Q. Can we focus now, please, on your implicit channels of pass-on. Can we look in your first report, paragraph 3.5.9 {RC-F/13/38}.
A. Yes.
Q. You are referring here to your implicit pass-on analysis, is that right?
A. Let me just quickly re-read. (Pause)
Yes, correct.
Q. As I understand it, you are identifying two primary implicit channels. Firstly, responding to competitors' prices and, secondly, budgeting and performance monitoring processes. So those are the two channels you our focusing on primarily; correct?
A. Yes, correct.
Q. There is evidence, of course, is there not, that merchant claimants closely monitor their gross margins, that is the difference between prices and COGS?

A. They do amongst others, yes.
Q. There is evidence that occasionally they operate with gross margin targets, or indeed targets by reference to other specific costs?
A. That is correct.
Q. Having a target and achieving it are of course two different things, are they not?
A. That is also correct.
Q. You are not seeking to go behind the factual evidence from the analysed claimants that they do not price by reference to the merchant service charges?
A. I mean, I think that they are factually correct statements as far as I am aware. But if I understand -- or my understanding of what they are saying is that if I was a buyer, and there are various terminologies for the people setting prices, depending on what industry they are in, but often they are called buyers, the buyer is obviously focused on a number of parameters that are important to themselves. One is obviously a cost of input that they can control, and another might be, for example, the prices of other firms.
So I think that it is factually correct to say that they would not have visibility of an MSC, ie as an input cost into the mix. Some do, obviously. There are a couple of claimants where we actually see that the MSC

is an impact at that higher level, and of course some do not actually have a gross margin as such and therefore you see a different mechanism. But in this instance, the point that I am making is it is not to challenge that evidence that they would be aware of the MSC. My point is whether indirectly that has been embedded into a gross margin target that they are trying to hit.

My view is that the EBITDA margin is likely to impact all other margins above it, because it is the end margin that a business is generally most concerned about. Having set the gross margin, it is true a buyer will not see the MSC on a day-to-day basis or on any basis, and that is a sensible thing, because they are being incentivised to control things that they can actually control.

Q. It is right, of course, that they cannot control the MIF component of the MSC, is it not?

A. That is correct.

Q. When assessing profitability, the merchant claimants' evidence suggests that overhead costs are assessed as a bucket generally; correct?

A. I think there is varying degrees. I think that we see evidence where certain costs, like energy, staff, freight, which predominantly amongst these claimants sit within overheads. Not always, sometimes those costs could actually sit within cost of sales; that would be allowed under International Financial Reporting Standards.

So there are instances of overheads that get particularly looked at, and within the monitoring we see instances when there is outperformance in other costs. That then may lead to a price challenge for the buying teams. So I think that we see those instances, but I also agree that at times they will be managing towards total overhead cost, and whether that total overhead cost is going to allow them to hit their EBITDA margins.

Q. The businesses are not likely to draw a clear distinction, are they, between a variable overhead cost, such as an element of staff cost, and a fixed overhead cost, such as a property tax?

A. Well, firstly, you do not see that distinction in the nature of the documents that we have received. Normally in a budget you would not expect costs to be classified as variable and fixed, but that does not mean that as a business they are not aware of that information.

So one of the claimants, for example, gave an analysis of its overhead costs and classified those costs between fixed and variable or semi-variable. I would expect that those sitting in divisions like the finance department would have an understanding --

I mean, the CFO is likely to have an understanding of what his costs are because that is needed for forecasting, at the end of the day. If you have a change in volumes, you will need to understand what that is going to lead to.

Now, what do I see in the financial record, again, noting that it is very sparse, is that I do not see them making -- when I see some of these costs, it is not clear whether they are making that decision on the basis that it is, in their view, a variable or a fixed cost.

Q. There is no way of breaking it down, is there? If the overheads categories include fixed, semi-variable and variable costs, that bucket is going to have a component of all three types of costs, is it not?

A. It is, but that does not mean that there are people within each of these claimants that would not have an understanding of which costs are variable, which are fixed and which are semi fixed.

Q. Obviously at a highly abstract level that must be right because, as you know from accounting convention, certain capital costs which are highly fixed, such as property, are subject to different write-down laws, are they not, for the tax code?

A. Are you talking about depreciation?

Q. Yes. So, for example, a large piece of property

infrastructure, you may have a 10 or 20-year write-down period over which the depreciation of the property is reflected in the tax accounting. Conversely, computer infrastructure, you may have a four-year write-down period on a straight line basis?
A. I think that is right. That is -- for write-down purposes, that would be in the tax accounts, so we do not see that within the P&L. But, to be fair, the same thing happens that if you buy a fixed asset, it will be depreciated through the accounts, and the tax write-down period may differ from the accounting period.
Q. But something like staff costs, where there may be a fixed component and a variable component, depending on the business, you are not going to have that level of granularity in the treatment, are you?
A. I would have thought that within a business it would understand the degree of variability. Many of these businesses, for example, have demand that changes through the week, and may also change over the season, depending on people's holidays and when things are busy, so for forecasting purposes you will need to understand how to match your people to that change in demand over time.
So I think they will have a degree of understanding. There will be some fixed contracts, but there will also

be, you know, a number of staff who are on variable contracts, and therefore it should be relatively easy for a company to be able to break down what costs are fixed and variable. Some might be more difficult, but I think labour would be relatively straightforward.

Q. Can we look, please, in your second report, paragraph 3.4.3 {RC-F/13/31}. As we have seen, one of your implicit channels is competitor pricing, that is what I am going to call it.

A. Yes.

Q. You are here -- this is the first report, sorry. It should be {RC-G/11/31}, the second report.

THE CHAIRMAN: This is not page 31, I do not think.

MR BEAL: Page 27, I am told. I am sorry, that is another dodgy reference {RC-G/11/27}. 3.4.3 hopefully has competitor pricing. Let me just ...

You are familiar with the concept of competitor pricing?

A. I am.

Q. Your basic proposition, as I understand it, is that a particular merchant can respond to competitors' prices, and that provides an implicit channel for pass-on of the MIF; correct?

A. Correct.

Q. Or the MSC, depending on how you want to skin that

particular cat. But of course here you do not know what a given competitor is setting its prices at, do you?
A. No. Unfortunately with the level of disclosure, I only have one claimant per sector, so it is not possible to look at the policies of a competitor.
Q. Now, one of the points you have repeatedly made is about the state of the evidence.
A. Mm.
Q. You are familiar, no doubt, with the suggestion that was made by my clients that there be a sampling process; correct?
A. Sorry, a ...?
Q. My clients suggested that there be a sampling process.
A. Yes.
Q. Mastercard, as I understand it, broadly supported that?
A. Yes, I think I would broadly support that.
Q. But that did not happen?
A. It did not.
Q. We are where we are.
A. We are. But I can only point out that that has limited my ability, and in places I think that it leads to quite a severe restriction on what I am and am not able to do.
Q. You are aware that the process by which the claw came down on a given claimant and then pulled it out of the box was based largely on the top ten claimants by -- top

ten sectors within the SSH claim. That was the initial starting point?
A. I understand that.
Q. What then happened is the experts discussed amongst each other, within that confine of the top ten, who among businesses within that top ten sector by claim value and by claimant entity would have the best data, and certain people were substituted out and certain people were obviously substituted in?
A. Yes, but I think the data that they were -- well, I do not know that process. I did not sit within the extraction of data for econometric analysis. But I suspect what they were looking for there was the best raw data that would go into their analysis.
Q. That was a conscious trade-off made by the experts in a joint process in order to provide the best available information to the Tribunal in the time available?
A. I think that that was the best they could do, given the direction of the Tribunal.
Q. Regardless of what may be the position with Mr Merricks' claim, which may or may not trouble this Tribunal in due course, we are, I think, confident, are we not, that for my clients we have at least a broadly representative sector of claimants for the SSH claim?
A. I have not done that analysis, so I will take you at

your word. All I can say is that whilst they may be representative, that does not mean that I have sufficient data for each of those representatives to be able to draw conclusions.
Q. We looked at this with Mr Coombs earlier. Were you listening to the cross-examination of Mr Coombs?
A. I was.
Q. Where, for example, there were 22 million observations for one company, and I think over a billion observations for another, one might think at first blush that that is quite a lot of data?
A. It is, but could I draw the Tribunal's attention to what I received, and I think diagramatically you will see the data that I am dealing with is completely different. So I think I can represent that quite easily by regard to --
Q. (Overspeaking) This is the document quantity list that you want to refer the Tribunal to?
A. It is --
Q. The number of documents produced by each claimant?
A. Yes. So if we were to go to my first report {RC-F/13/33}. This chart is on my first report, so the data that I received by each of the claimants.
Q. But this does not include the subsequent data request process, the Redfern process and where we are now;

correct?
A. No, I can go to that too.
Q. Let us do that, because that will give us the complete picture, will it not?
A. It will give us the complete picture, but it does not move the overall dial on information, because there is still significant information that is still outstanding on the Redfern.
Q. Never mind the quality, feel the quantity. Is that what you are suggesting?
A. Well, I am just going to say what I think you can say about the quality.
Q. Which documents do you think you are missing and why were they not in the Redfern request?
A. They are in the Redfern request.
Q. The Redfern request has been adjudicated on by this Tribunal?
A. Yes. But I still do not have the information to be able to make a decision on that. There are a number of documents, important documents, such as the mechanism of how an end profitability EBITDA would go into a gross margin. I have almost no information on that.
The second --
Q. (Overspeaking) -- evidence is from a witness but it does not. How are you meant to prove with a document

something that does not happen?

A. Well, I think that what the witnesses say is that the buyers do not have regard to the MSC. It is not addressing the very narrow point of how is the gross margin determined, and that is the piece that is missing in the Redfern.

THE CHAIRMAN: You are saying what you have not had is the proof of how you think it worked?

A. Yes, correct.

THE CHAIRMAN: Right. It does not work that way.

MR BEAL: Correct.

A. But I do not have in it any way. I mean, the number has to come up with -- it has to come from somewhere, and what I do not have is where it has come from.

A second level, and, again, I think this is in the Redfern, where I do not -- is what the monitoring process shows you is where there is under and overperformance, but many of the documents have no description of what action is then taken. Generally speaking, you do not go to an extreme level of detail of looking at under and overperformance and there to be no decision from that.

So that is another category of documents that, when I worked on *Sainsbury's*, we had a lot of those types of documents, so, I mean ...

THE CHAIRMAN: So I am just trying to understand your expertise in this area. You want those documents to be able to interpret them --

A. Yes.

THE CHAIRMAN: -- to tell the Tribunal how it worked as a matter of fact?

A. Yes.

THE CHAIRMAN: But why can we not do that from the material that we have?

A. Because -- well, I guess for two reasons -- well, I mean, you can, obviously, but the Commission's pass-on document, when it is talking about approaches to pass-on, makes it very clear that understanding the quantitative analysis is an important input into the econometric analysis, and that is the part of that notice that I am trying to fulfil by assisting Ms Webster on the mechanisms of pass-on, and one can only do that for the purposes of the econometrics at a point before you have heard that evidence, otherwise they would not have the quantitative analysis to be able to do that assessment.

As I said, many of the experts have commented on the evidence from the approach that they have taken to inform their analysis. I have looked into a deeper set of analysis, a deeper look into the documents, to see if it is consistent with what is being said in the witness statements and to try to fill in gaps that I have in the analysis.

PROFESSOR WATERSON: Can I just understand: so were you part of the Redfern process or not?

A. Yes -- oh, the Redfern, yes, myself and my team have been --

PROFESSOR WATERSON: So did you ask for such documents and they were not produced?

A. Yes, yes, and that is why there are still some outstanding Redferns highlighting the areas that I did not get sufficient information.

Where there was more information, one of the claimants produced almost 2,000 documents over a longer period of time, that provided -- you know, it allowed me to fill in the gaps for that claimant. But the majority of the claimants produced, in the first instance, most of them, less than 50. One of them provided something like ten, and one did provide 70, but 30 of those were pages of logos which obviously were of no assistance.

PROFESSOR WATERSON: Did the logos change much over the period?

A. The logos were the same over the period.

THE CHAIRMAN: Maybe they cost quite a lot.

A. So I make a point that I am missing information because

I want to make clear that my analysis can only go so far, and in my reports I make very clear how far I can go because I have insufficient documents.

MR BEAL: Coming back, if I may, after that detour to deal with procedural wranglings, you do not know how a given competitor has set its prices, do you, when you are looking at a particular analysed claimant?

A. For one of the claimants, I think we have some information based on, you know, my understanding of those practices in a different case.

Q. Was that evidence before this Tribunal?

A. Well, we are talking about the *Sainsbury's* case, which --

Q. Is the *Sainsbury's* evidence before this Tribunal?

A. No, I am just bringing it up because we discussed that earlier, and obviously --

Q. Some might say that is an absence of documents on your part, proving what happened in *Sainsbury's*?

A. I was not asked to disclose any.

But, in general, the point is that I do not, obviously, have evidence on each of these claimants, because I have no documents that would sit, you know, with those claimants to help me answer that question. So I have indicated that it is a mechanism. What we know, for example, is that they look at price comparisons almost on a weekly basis, so they are comparing, and it is a big part of their businesses.

The point that I make in my reports is that to the extent that those comparators, and it is not just to one competitor, it is often two or three. To the extent that one of those competitors was to choose to lower its prices because of a lower MSC, then that would be a mechanism by which pass-on occurred.

Q. So let us just imagine putting, hypothetically, a series of supermarkets together. So we have Primark, with whom Mastercard have settled the case, so they are no longer involved.

A. Yes.

Q. On your analysis, Primark look over their shoulder at pricing by a competitor, such as Marks & Spencer's with whom --

A. Well, I think in the record there are other competitors that they look at.

Q. You have no evidence that Marks & Spencer's have built the MIF overcharge into their pricing, so with Marks & Spencer's you would then have to look at another unknown competitor from whom they are deriving their implicit channel of pass-on of these prices?

A. Well, we know that -- again, I am constrained a little bit by confidential information -- but we know that there are other competitors that they are benchmarking to.

Q. But you do not know that other competitor is directly including the MIF overcharge in its pricing, do you?

A. No, we do not.

Q. So the whole thing becomes circular. I mean, let us take *Sainsbury's*, which you seem to know an awful lot about. *Sainsbury's*, for example, we know they did not pass on, because that is the finding from the Tribunal, for the period up to 2015, so we know for a period in 2015 they were not passing on the MSC. So if Tesco were to look at *Sainsbury's* and price by reference to their pricing, they would not be passing on either, would they?

A. Well, in -- so *Sainsbury's* is one of the benchmarks that they look at, but they also look at --

Q. But we know, because the Tribunal has found, and Mastercard appealed against this and lost, *Sainsbury's* was not passing on?

A. Again, I think there is potentially a difference between the legal pass-on and economic pass-on, as I explained before. I do not think that I need to go into that again, but we know that Mastercard also benchmarks itself to Tesco's, and Mr Mourant is on record to say --

THE CHAIRMAN: Not Mastercard, I think.

A. Pardon?
THE CHAIRMAN: Mastercard does not benchmark against Tesco's.
A. Sorry.
THE CHAIRMAN: I do not think, anyway.
MR BEAL: Not at 0.2% it does not.
A. I mean Primark --
THE CHAIRMAN: Primark, yes.
A. -- benchmarks to Marks & Spencer's, and I know that both of them benchmark to other grocery firms, including Tesco, and Tesco is on record to say that it would pass on MSCs through pricing.
Now, it is not for me to determine --
MR BEAL: Just pausing there, where is that record?
A. So this is -- this was in the same section when we were talking about the BRC. I also refer to Mr Mourant from Tesco who gave it in evidence.
THE CHAIRMAN: Is that in 2006 or something?
A. I cannot remember the date offhand.
MR BEAL: This is evidence you relied on in the *Sainsbury's* trial in 2023, is it not?
A. That was.
Q. It was not accepted. A slightly unpromising start for relying on this.
A. Well, it is for the Tribunal to put what weight they

will on that.
Q. Can we move on to performance targets, as time marches on. Your implicit route of performance targets is essentially that a counterfactual might have produced lower prices for customers on the basis that, as a result of having more headroom in one's performance margin, the reaction of the firm would be to reduce prices; correct? Because we are dealing here with a price decrease. So MIFs have gone.
A. Yes.
Q. A brand new world post-IFR, MIFs have been decreased. That cost reduction, you say, gives an implicit route by which a firm may choose to lower its prices as a response?
A. It does so on the understanding that there is a link between EBITDA and gross margin, yes.
Q. But you are not actually able to show, are you, any example of firms doing that in practice?
A. I am not, and my reports make that clear.
Q. So you are making assumptions as to what they might have done in a counterfactual scenario, which actually is not borne out by the real world examples that we have seen, is it?
A. Well, it is a -- I mean, I state very clearly that it is a potential mechanism that I have been unable to

determine, because I do not have access to data, that would say what those competitors would do, and I say that to the extent that they did, then that would be a route. I do not say that it definitely happens, I say that that is a potential mechanism.

Q. You would accept, would you, that a potential change, increase or decrease, in, for example, the cost of goods sold, is likely to have a pretty direct impact on the direct pricing of a product, because it is a very direct link between that and the price at which the product is sold?

A. Yes, I would agree.

Q. Conversely, an increase or decrease in an overhead is not going to have the same direct impact, is it?

A. I do not know whether I can conclude that generally, because I think it depends on what type of overhead it is in terms of potentially whether it is fixed or variable, but also, more importantly, whether it is a common cost or whether it is firm-specific. I think that there is generally more likelihood of pass-on if a cost is common across the industry.

Q. But it follows from this, given that your EBITDA margin includes both cost of goods sold and overheads costs --

A. Yes.

Q. -- it is going to be very difficult to identify, is it

not, what the particular trigger for a given price increase or decrease at downstream level is?
A. The direct link is certainly less clear, but I think that it is also less clear -- the direct causality even at the cost of sales level is difficult, because you do not quite know which prices are changing in response to different cost changes. It is for the buyer to determine which prices they are going to change, and many factors will come into that as well.
If the general question is: do I think that the overhead route is less direct, then the answer is "yes", because I state that one is a direct route and the other is an indirect route in my reports.
Q. Purely as a matter of economic theory, if a firm is pursuing a profit-maximising strategy, it will set its prices so that it covers it marginal costs; correct?
A. That is the theory.
Q. Marginal costs, I think we can equate, can we, with the cost of goods sold, because that is the primary marginal cost going into a particular sale?
A. Well, I think that economics does not make the distinction between cost of goods sold and overheads. From a factual statement, the cost of goods sold is not just variable costs, it can include an allocation of overhead costs. It is governed by International

Accounting Standard number 1, which is the presentation of financial accounts. There are various ways in which a company could account for their costs.

The cost of sales figure generally speaking relates to the cost of bringing an item to sale, and there is then therefore a judgment as to what costs are included. Some may think about only the variable costs. Others may think about allocating, for example, fixed costs. Some may decide that they do not want to make that allocation, and therefore the overhead costs could include a group of costs which are variable at the end of the day.

Q. Let us just keep it very simple. Imagine there is a retailer of T-shirts.

A. Yes.

Q. What they do is buy T-shirts from a third country outside the UK, they import them and then they retail them on the high street. The primary cost component for their downstream sale is going to be the cost of the T-shirt, is it not, together with import duties, etc; that is going to be the primary component?

A. Well, I think that that is true, that you start -- but they then still need to understand what margin do they need to add on to those costs to be able to return the profit that the company needs at the bottom level. So

they are not just going to price based on that cost,
because if they just priced on the cost, they would not
generate enough revenue to get a profit at the end of
the day after fixed costs.
Q. So having selected the best price, imagine that that
primary component does not change, and therefore all the
company knows is its basic stack of costs have not
changed. Its price is working, they are happy with the
revenue they are getting, but their management reports
suggest that the EBITDA has fallen. So imagine that is
the scenario.
A. Mm.
Q. The company is going to be mad to change its prices in
the dark without knowing what has caused the EBITDA to
fall; no?
A. Yes, it would need to know that.
Q. If in fact all it knows is that overheads have increased
for a particular line of overheads, surely it is not
going to immediately increase its prices in response.
It may choose to try and reduce the level of overheads,
so cost reduction?
A. It could do either one of those strategies, yes.
Q. It may choose to defer capital expenditure and pull in
the horns elsewhere; correct?
A. It might do. I state in my first report that that is

typically a less obvious route, because capex does not sit within the P&L account, it goes on to the balance sheet. So changing the amount of capex in your business does not actually change directly the cost in the P&L. So you might choose to do that, but normally capex -- a lot of capex is spent because you are expanding and --
Q. Capex is going to be a fixed cost that you have to recover in the long-run according to your analysis; correct?
A. Capex is a balance sheet cost that will need to be recovered in due course.
Q. I thought your evidence was that implicitly somewhere in the gross margin the firm will have that at the back of its mind?
A. No, I think that the capex decision, which is not a P&L question, has a different question. It is whether they have sufficient funds to be able to spend on capex with a view to making money on that capital expenditure. So I do not think that example is --
Q. Let us move from a quite obviously fixed cost, like a capital expenditure on a building, to something that is semi-variable, like labour.
A. Yes.
Q. One response to a squeeze on the EBITDA margin would be to let people go?

A. It would.
Q. Now, let us flip it round and say, right, you are in the happy position where your EBITDA has increased. You do not know why. Why would you drop your prices, necessarily? You would want to understand why your EBITDA was improving, would you not? Assume you fixed your -- you are happy with your pricing based on cost of goods.
A. Mm.
Q. You are happy with the revenue you are getting based on cost of goods. You get this happy situation where you notice there is an improvement in your EBITDA.
A. Yes.
Q. Why would you drop prices? Why do you not just say: this is great, we have more profitability?
A. Well, I think in -- well, if that overhead was a variable cost, then there is a shift in the supply curve. That would -- well, it would -- and that leads you to a new price maximising --
Q. I only look quizzical because when I put the economic theory to you, you said that is economic theory only and you moved to the pragmatic example. So I have moved to a pragmatic example and you are now giving me economic theory. I do not mind which we do, but let us do them one at a time, perhaps. So, right, give me economic

theory.
A. Well, the economic theory is that if an overhead includes a variable cost, according to theory, that will lead to a different price-maximising point because the supply curve, the marginal cost curve, shifts either left or right, depending if it is up or down.
Q. That assumes that the variable cost you have identified is a marginal cost that goes into the profit-maximising formula for the short-run trade-off between marginal revenue and marginal cost; correct?
A. It does depend on that, and, as I said, economic theory does not make a distinction between where the variable cost sits.
Q. Now, if, switching to the practical, the business does not treat a particular cost in that way as a driver for the short-term trade-off between marginal revenue and marginal cost, then it is necessarily not being factored in directly to the pricing matrix at that point, is it?
A. If the business chose to treat a fixed cost as a -- an overhead, a particular overhead as a fixed cost, if it was a variable cost, then that would be the conclusion.
Q. Well, forget fixed and variable. I am dealing with the pragmatic point that overhead costs, if they are not factored in to the pricing decision -- look, let us step back.

If you are right that the MSC is a marginal cost that features in the pricing calculus in the short-term by the profit-maximising firm, you do not need to rely on your implicit channels, do you, because you have a direct connection, that is it, game over?

A. Correct.

Q. Now, it is fair to say that your extensive expert evidence in this case does not posit that as being an answer to the Tribunal's enquiry, does it?

A. So can you unpack that?

Q. All of your evidence is about implicit channels, not about direct mechanisms?

A. Well, that's not true. I think for at least two of the claimants I say they are explicit.

Q. Okay. I will come back to that tomorrow morning when we go into closed session. I will look at those two claimants and see how far that is correct.

As a general proposition, if you thought, as a matter of economic theory, a shift in the demand curve meant that MSCs were going to be treated as a marginal cost and factored directly into the pricing trade-off, marginal revenue, marginal cost, you would have said that in terms in your first and second reports?

A. Sorry, I am just re-reading. You said that very quickly. (Pause)

I think that in my second report I make a distinction that I do not opine on variable and fixed costs. What I seek to do, when I am looking at proxies, is just to comment on the degree to which overheads are likely to be fixed and variable.

Q. So let us have a look at {RC-G/11/7}, please, paragraph 2.1.2. So this is your second report. What you say here is:

"The other parties' experts adopt a range of approaches to assess Price Pass-on in respect of the Merchant Claimants' businesses and they engage to different degrees with the qualitative evidence. I do not comment on all of the other experts' analyses. In particular, I do not comment on the other experts' assessments of pass-on from the perspective of economic theory or their econometric analyses."

Do you see that?

A. Correct.

Q. So you have been giving me an economically theoretical answer. I am happy to engage with you on that, but my point I am making to you is that is not the way you structured your reports?

A. No, it is not, but you asked me a question that therefore is best answered in that way.

Q. I am happy for you to deviate where you want to into

economic theory.
My suggestion to you is that, as a matter of economic theory, it is no good looking at a marginal cost analysis if in fact the firm does not in practice treat the cost as a marginal cost going into the short-term calculation of price.
A. I think that I said that. I said that it would depend on how the company had regard to that cost.
Q. So if in fact what we are dealing with here is a very small decrease in overhead costs as a result of a reduction in the MIF, which is a small part of the firm's costs -- it feeds into the MSC which is a small part of the firm's costs -- the reality is if the firm were to -- even if the firm knew about the decrease in the MSC, it is not going to move the dial on the pricing change, is it?
A. Well, I am not sure. What I identify in my work is -- it is not just about how big it is as a function of revenue, it is also how big it is in response to the actual level of profitability. Many of these claimants are highly competitive and they are operating on very thin margins. If you are operating on thin margins, even small costs as a percentage of revenue are likely to impact the overall level of profitability, and I have some examples of that.

Q. As a percentage of net margin which is the argument you are now running, the cost of goods sold in the stylised example I have given you, the cost of the import of the T-shirt, is going to be far and away the biggest cost; correct?
A. Yes.
Q. That is going to dwarf the net margin by a multiple factor?
A. Yes, that is correct. But if the margin at the end of the day is tiny -- so in your example, let us say the T-shirt costs 95, and you sell it for 100, and so there is a 5 profit, so that is a 5% profit margin, then an MSC --
Q. Gross profit margin?
A. Well, I was assuming that there was virtually no overheads in this example, but I think that it is -- because you did not put any forward in your assessment, so ... It is the same if you had overheads in there. But actually if you have overheads in there it becomes even more important, because that is going to reduce that profit even further.
So in my example, let us say that overheads were 2. So we have a 5 gross margin, which is -- sorry --
Q. 5 gross margin, 3 operating margin, on your analysis.
A. Correct.

Q. Of which the 0.2% debit card charge is going to be a factor of 10 compared to the -- sorry, 3% divided by 0.2 will give you what the relationship is; correct?
A. But for some, that percentage is much higher.
Q. Well, for some.
A. Yes.
Q. In certain industries.
A. Yes.
Q. Where the margin is very low.
A. Okay. So the other bit that I can add to this, and I think it is important, is when they are doing their monitoring of cost deviations, they are observing cost differences much smaller than the level of the MSC. So these firms are big. They have the ability to understand where a cost has deviated from plan, and it is that deviation that will be picked up through their processes.
Q. The counterfactual analysis: you would accept, would you not, that there have been some non-transitory changes to MIFs over the course of the SSH claim period?
A. Yes.
Q. So January 2015 with the Visa commitments, December 2015 with the IFR caps. You are familiar with the later Visa commitments decisions as well?
A. Yes.

Q. These provide price points, do they not, at which changes in the MIF might have led to a conclusion that prices have changed as a result?

A. Yes, that might do, and I assume that that is picked up in the econometric analysis.

What I have said is that for most of those changes, I do not have data that is sufficient for me to identify those changes.

Q. That applies even with a company that we will come on to tomorrow morning, which is probably the closest to having a very tight net margin, and where they expressly take into account the MSC as a cost that goes into their pricing in general?

A. Yes.

Q. So if anyone was going to reveal the impact of a reduction or increase in the MIFs, that would have been the candidate, would it not?

A. Yes, but it also depends at that time what else was changing.

As I have said, I mean, you can look at one cost change, but when you observe one cost changing, there could be other costs that distort it, but I am sure we will come to that tomorrow.

Q. The first thing we are going to come to tomorrow is supplier pass-on, but I am going to reserve that delight for tomorrow morning rather than now, and then I hope we will get on to the merchant-specific material.

THE CHAIRMAN: Do we need to start earlier tomorrow or ...

MR BEAL: I am hoping to be done by lunchtime, if that assists.

THE CHAIRMAN: Lunchtime. Okay.

MR BEAL: It depends slightly on the length of the answers, but assuming one is with a fair wind, one is finished by lunchtime. I may slightly dribble into the afternoon, but I understand my learned friend Mr Williams wants an hour, and I do not know how much re-examination there is at the moment, probably not very much.

THE CHAIRMAN: You want an hour.

Visa?

MS BOYD: Yes, I expect to be less than ten minutes.

THE CHAIRMAN: So we should be okay starting at 10.30?

MR BEAL: I am not pushing to start earlier, if that helps.

THE CHAIRMAN: We will not then.

10.30 tomorrow. Thank you.

Do not forget, Mr Harman, that you are giving evidence and so not to discuss the case with anyone.

THE WITNESS: Absolutely.

THE CHAIRMAN: Thank you.

(4.30 pm)

(The hearing adjourned until 10.30 am

on the Thursday, 5 December 2024)