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)

Monday, 2 December 2024

(10.30 am)

Housekeeping

THE CHAIRMAN: Good morning. Can we just have a little discussion about timetable before we start with Mr Coombs.

I assume you have all been having a little look at it, to see if we can accelerate matters in the light of what has happened. I assume we will -- you are intending to start with Mr Harman this week, that is on the timetable, but it will be good if we could actually complete him this week, if that is going to be possible? We have obviously saved the time that we were going to spend with Mr Holt this morning, and so we would hope that might be possible.

Have you been discussing the timetable amongst yourselves?

MR BEAL: It might assist if I perhaps volunteer this: looking at the current timetable, Mr Harman is down for Monday, 9 December for a cumulative period of 1.8 hours.

THE CHAIRMAN: Yes.

MR BEAL: I would be hopeful that we can squeeze that into this week, so that he does not need to be in purdah over the weekend, and we start with Mr Economides first thing on Monday.

THE CHAIRMAN: Yes. Well, that is what we were hoping.

MR WILLIAMS: That is also our expectation. On behalf of Mr Merricks, we expect we will need just over an hour for him. Originally we had budgeted for one hour. In light of the settlements on behalf of Allianz and Primark, we hope to take about 15 minutes' additional. It will not take us over, but it might therefore be prudent to begin early on the Thursday so that all the cross-examination can be completed with Mr Harman on that Thursday. If he starts at 10.00 am on the Thursday and then finishes by 4.30, that should be possible, but I did just want to alert that we may be a little bit more than an hour.

THE CHAIRMAN: All right.

Okay. Then obviously that would mean, if we do, we can start with Mr Economides first thing on the following Monday, and perhaps get through Ms Webster by the end of that week. All right, well, let us see how we go.

So good morning, Mr Coombs. You will need to be sworn in.

MR JUSTIN COOMBS (affirmed)

THE CHAIRMAN: Please sit down, Mr Coombs.

Examination-in-chief by MR WILLIAMS

MR WILLIAMS: Good morning, Mr Coombs. Please could we go to {RC-F/10/1}. You should also have this is in hard copy in front of you, and it will be the first tab, Mr Coombs.

You should see in front of you, both on the screen and in hard copy, your thirteenth expert report. Do you see that?

A. Yes.

Q. Would you please turn to page 390 in that document {RC-F/10/390}. You should see on screen, if not in hard copy in front of you, a declaration of statement of truth. Is that your signature?

A. Yes.

Q. Is the statement true to the best of your knowledge and belief?

A. Yes.

Q. Aside from any updates or corrections that are already set out in your fourteenth report, are there any corrections that you would like to now make to this thirteenth report?

A. No.

Q. Could we then please turn to the second tab in your hard copy document and to {RC-G/9/1}. You should there see on the screen, and in front of you in hard copy as well, a copy of your fourteenth expert report in these proceedings. Would you please turn to page 440 in that

document {RC-G/9/440}. You should see there a declaration and statement of truth. Is that your signature beneath that?
A. Yes.
Q. Is that statement of truth true to the best of your knowledge and belief?
A. Yes.
Q. Are there any corrections that you would like to make to your fourteenth report?
A. No.
MR WILLIAMS: I am grateful. If you could please wait there, Mr Coombs, my learned friends will have some questions for you, starting with Mr Cook on behalf of Mastercard.
THE CHAIRMAN: Mr Cook.

Cross-examination by MR COOK

MR COOK: Good morning, Mr Coombs. You have given a lot of previous reports, so we are on your thirteenth and fourteenth now. For simplicity, I will probably refer to them as your first and second reports, as being the relevant ones in relation to pass-on, and if we need to go back into some of the historic ones, I will give you those by number. That is just so you understand that that is what I am referring to, I am not trying to dredge back what you said four years ago in general.

Now, you say at paragraph 1.112 of your first report that your objective is to measure the long-run cost pass-on rate. You define the long-run as the period in which all costs are variable which will depend on a firm's investment cycle. Is that -- that remains your position, does it?
A. Yes.
Q. Just to understand the context here, you accept that economic theory indicates there are likely to be differences in at least the speed of pass-on for variable and fixed costs?
A. Yes.
Q. That is because economic theory identifies different potential pass-on mechanisms for different types of costs, does it not?
A. Yes. I mean, I would say it is to do with different mechanisms. It is also to do with the fact that obviously some costs are changing; variable costs are changing immediately, fixed costs change at some point in time, and therefore inevitably pass-on takes place once those costs have actually changed.
Q. Yes -- well, yes, I mean, obviously you cannot get a pass-on of a change until there is a change?
A. Yes.
Q. But once you have had a change, economic theory

identifies sort of a different mechanism and, therefore, as a result of that, timescale for that change being passed on, does it not?
A. Yes.
Q. Where a merchant prices by reference to a cost, the theory is that changes in that cost will often be passed on relatively quickly. Is that right?
A. Sorry, I did not --
Q. Where a merchant prices by reference to a cost, changes in that cost will often be passed on relatively quickly?
A. So you mean where a merchant is, in its price-setting, monitoring a particular cost?
Q. Then directly pricing by that.
A. Directly pricing by it, yes.
Q. But you do note in your report that, in practice, an increase in costs is likely to be passed on more quickly than a reduction in costs. That is just what we see in practice, is it not?
A. That is often the case. I would not necessarily say it is always the case, but it is often the case, yes.
Q. That is reflected in the popular observation in relation to the petrol market, that prices go up like a rocket and down like a feather?
A. Yes.
Q. You are familiar with that?

A. Yes.

Q. Now, you refer to the fact that economic theory says that pricing by reference to variable costs will be the efficient thing since firms should price by reference to their short-run marginal costs; that is what the theory says, does it not?

A. Yes.

Q. But in the real world, merchants do not have complete and cost-free information, do they?

A. No.

Q. There is often complexity in costs involved in monitoring costs and adjusting prices by reference to them, are there not?

A. Yes. So if you like, there are costs involved in understanding their costs and reacting to them by changing their prices, yes.

Q. You say, if you go to paragraph 2.4(c)(ii), page 27 of this report {RC-F/10/27}, the one at the top of the page, then you say in the last sentence, having made observations about what economic theory says:

"A rational retailer would treat the MSC as a variable cost as to do otherwise would risk them running at a loss over the longer term."

When you talk about treating the MSC as a variable cost, you mean they should include the MSC in the

calculation of short-run marginal costs by reference to which they should price; is that what you mean?
A. Yes. So the MSC is a variable cost, and therefore you would expect a merchant to treat it like a variable cost in its pricing decisions, yes.
Q. But there might be sensible commercial reasons why a retailer decides to focus on its main cost inputs in its short-run pricing decisions, rather than every single small cost. Would you agree with that?
A. Yes. So your point is that the size of the cost is relevant in the short-run, yes.
Q. So, I mean, it may just simply be not cost-effective to try and do it in a way that economic theory says would be efficient but in a world where, in practical terms, it is costly and difficult sometimes to quantify and then adjust prices?
A. Well, I would put it slightly differently. I think economic theory recognises that there are transactions costs or menu costs involved in changing prices, and therefore that affects the speed with which a small increase in cost is passed through.
Q. Yes, but I am asking you about a separate point, which is it is not simply a question of menu costs which potentially delays you making a price adjustment; it may just simply be something where it is costly to monitor

and calculate a small cost, and so you do not incorporate it into your pricing in the way you would for costs which are really rather important to your business?

A. Yes, I think we are actually talking about the same thing. I am not sure there is a distinction between the two.

Q. I am just -- it is my understanding menu costs relates to the -- I mean, the classic phrase is a restaurant is not going to reprint its menu every day, so it is that process of adjusting costs has a cost to it --

A. So --

Q. -- and I am distinguishing the process of simply deciding what you price by reference to, there will be a cost of trying to analyse every single small cost perfectly for that process?

A. Yes. Maybe we are getting lost in terminology here, but I am talking about transactions costs, so not just menu costs but other costs that would be incurred in terms of monitoring costs and changing prices in response to that.

Q. Okay. Thank you. I think you acknowledge in any event that it is not necessarily the case, based on what you have seen, that merchants do price in the short-run by reference to MSCs?

A. Sorry, I did not quite follow the question.
Q. I think you acknowledge that it is not necessarily the case that merchants do in fact price, in the short-run, by reference to MSCs?
A. Well, certainly some merchants say that they do not, yes.
Q. Thank you. Well, you say in paragraph 3.121 of this report, page 102 {RC-F/10/102}, you refer to the fact that the evidence shows many merchants recording MSCs as an operating cost. There is a question about what they then do with that, but they are not categorising it as part of their COGS, are they, in many cases?
A. Yes.
Q. I am not going to address with you what the evidence does or does not show in relation to how operating costs are taken into account. What I want to address for the moment is what you say is the mechanism for fixed costs being passed on, and you make the point at the top of page 16 of this report {RC-F/10/16}. At the top of the page, you say:
"To account for the possibility that some costs, such as operating expenses, may take longer to feed into prices than others, such as direct costs ..."
You are talking here about why you consider it is appropriate to look at total costs.

A. Sorry, I did not get what the question was there.
THE CHAIRMAN: Where were you reading from?
MR COOK: The top of page 16, where it says:
"To account for the possibility that some costs, such as operating expenses, may take longer to feed into prices than others, such as direct costs, [you] run alternative ... specifications ..."
So I was focusing on just the words, which is what you are identifying there is that there is a possibility, you say, that some costs, such as operating costs, may take longer to feed into prices, and that is perfectly realistic and reasonable, is it not?
A. Yes.
Q. Now, economic theory identifies a different mechanism for the pass-on of fixed costs, does it not, and that is to do with investment decisions?
A. So I think -- well, this is where I think it gets a bit complicated, because there are different types of costs which might be viewed as being fixed in the short-run that become variable in the long-run, and the mechanism can vary depending upon the type of cost. So I think that is -- I think that is the point you are making; yes?
Q. Yes, the mechanism of that, but I am focusing on,

avoiding some of the complexity here, a cost that is, you know, genuinely something you would describe as a fixed cost, one of the big ones like, you know, the cost of building a new building, opening a new store, those kind of things, that are keeping us away from the MSC scenario. Big fixed costs. Economic theory identifies a different mechanism for those to be passed on, does it not, that those will be passed on through changes in the size of operations?

A. Yes.

Q. So when you say that pass -- and you say those costs will eventually have to be passed on. You recognise that is a process that might take a considerable period of time?

A. Well, it depends what you mean be a considerable period of time. I am saying it would take longer than it would for a variable cost.

Q. Well, and how long it takes will partly depend on the timescale over which a merchant can change its size of its operations. If it signed a ten-year lease, it may not be able to do it until the end of that ten-year lease, for example?

A. Yes, if you are talking about that particular cost, the cost of property, then, yes, that will be relevant.

Q. So when you are talking about fixed costs like that, the pass-on mechanism depends on the timescale when a merchant can change those kind of costs; it is the investment footprint?

A. Yes.

Q. Now, when you say in your report, and it is, for example, 2.87, that in the long-run all costs are variable, what you are doing is you are talking there about that kind of process, potentially, with some costs, changes in the investment footprint, not that they are going to be brought in, in the way that marginal costs potentially could be brought into short-run pricing decisions?

A. Yes.

Q. Now, let us talk then about the pass-on of fixed costs. In the context of a small increment on fixed costs, it is very unlike that that small additional will in fact have any effect on whether an investment takes place or not, would you agree with that?

A. Well, I think it depends on the circumstances, does it not? Because, I mean, the point is that small costs accumulate, so it depends whether you are looking at a small cost in isolation, or you are taking account of the fact that it accumulates with other small costs, and therefore eventually becomes cumulatively a big cost?

Q. Well, what I am identifying or asking you about here is obviously a merchant may well aggregate certain numbers of costs, but the cost that it builds up is only going to be very marginally different if you are just talking about the addition of one small bit on top of it and I am saying it is very unlikely that that will actually have any effect on whether investment takes place or not?

A. Yes, I think there is a sort of potential fallacy here, which is that you then sort of say: well, none of these small costs have influenced the investment decision, which I think is the wrong way to think about it. So if you have a series of small cost increases that accumulate over time and they become a big cost increase, there is going to be sort of a pivotal small increase in cost which causes a change in behaviour, causes the investment decision.

Now, one way of looking at that is you say: well, it was that one small cost that caused the change in behaviour, caused the investment decision. But I think that is the wrong way to think about it, because it is not that small cost in isolation, it is the accumulation of all of those individual small costs, and they have all individually contributed to that decision.

Q. Well, there may be a tipping point when something becomes a good investment decision or, in reverse, where

something ceases to be a good investment decision and
you want to scale down.
A. Yes.
Q. But the reality is, when you are talking about a small
increment, it is unlikely that most of those decisions
will be any different, based on that small increment or
not?
A. Yes, as I say, I think that is the wrong way to think
about it, because I think then you are basically saying
it is only the pivotal change in cost that has had an
effect on the decision, and I do not think that is right
way to think about it. The right way to think about it
is that it is the accumulation of all of those small
cost increases which have caused the decision.
Q. But if you are looking at whether something would have
been different in a counterfactual, in that realm of
analysis, you would agree with me that actually, when
you are talking about small costs, most of those
decisions would have gone the same way, for or against
investment, if there is just a small increment?
A. Well, if you take it -- if you are looking at, say, one
individual firm and one individual decision, that will
be true. But, of course, that is not what we are
looking at here, we are looking at the picture across
the whole economy, across all retailers in the UK. So

I think you have to take account of the fact that, okay, in most cases this decision -- well, it depends what we are talking about here.

We are talking hypothetically about some small change in fixed costs, and you are saying, well, if you look at any of these individually in isolation, most likely that would not have caused a change. But what I am saying is if you look broadly across the economy as a whole, you will see that, well, some of them will and some of them will not, and the correct way to think about it is they have all contributed to these decisions.

Q. I think you may be in areas where economists and lawyers disagree about what constitutes pass-on, but ...

In terms of -- if we assume, based on what you have been saying, that small fixed costs are capable of having an effect on investment decisions, I mean, you have not given any thought or done any analysis of what the investment cycles are for any of the businesses or sectors that you have considered, have you?

A. Well, I have, and I will struggle to, amongst these thousands of pages, be able to point you to the right place. But what I did do was I looked at the extreme case, which is the one you just mentioned a little earlier, Mr Cook, which is property leases and how long are property leases. The point I was just sort of making is that if you look at the average property lease -- well, two points. Firstly, in some way that is the sort of slowest change in cost. So for most firms, changing -- moving their business to a different property is sort of the ultimate long-run cost, something that only happens very rarely. Most other fixed costs will change more frequently than that.

So if you take that extreme case and you look at how long the leases were, I cannot remember from the top of my head exactly what the number was, but the point was it was clearly a period which is much shorter than the period that we are looking at in the Merricks claim period, and given that is sort of the longest period that one would consider, when one is thinking about what is the long-run, the actual -- the long-run in reality is going to be much shorter than the Merricks claim period.

I am not quite sure if I am addressing your question but I think that is what you were getting at.

Q. That is indeed what I am asking about. But even on that analysis, you are saying it would take time for the costs we are talking about. So there would not be an impact on prices for some time, and that could be measured in years?

A. Potentially, yes.
Q. You just really -- you have not done any analysis of how many years we are talking about?
A. In terms of looking at investment decisions and how long they take, no, I have not done that analysis.
Q. You say, at paragraph 3.67 of your first report, that qualitative data may shed light on the timescale of pass-on. That is at page 84 {RC-F/10/84}.
    You say you do not consider it assists in the quantification of a pass-on rate, but while merchants' pricing strategies may shed light on the short-term considerations, as such may be informative of latency, so delay.
A. Sorry, which paragraph?
Q. Paragraph 3.67 at the top of the page.
    You start by saying:
    "I consider that qualitative evidence on how merchants treat the MSC or whether they explicitly considered it in their pricing does not assist the quantification of a pass-on rate."
    Then you say it may be informative as to latency, in the next sentence.
    Just to deal with whether it assists in a quantification, and, again, stepping away for a moment from the MSC, if we are talking about, as we have

identified, different potential mechanisms of pass-on, we certainly see in your numbers a range of different pass-on rates. Presumably you would recognise you could equally get different pass-on rates depending on which mechanism is operating?

A. So if you were looking -- so if you were comparing a short-run pass-on rate with a long-run pass-on rate, you might find that the two are different. Is that the point that you are making?

Q. The point I was asking you about is when you have different mechanisms for pass-on, those mechanisms may be more or less effective than each other. So the mechanism that passes on variable costs into short-run pricing may be more or less effective than the mechanism which passes on the extreme fixed cost into long-run pricing?

A. So I think the point I am making is that the time it takes for that change in cost to feed through into prices may be different.

Q. I was asking you about the fact that if you are, as you are, identifying the fact there are potential different mechanisms, you will presumably accept those different mechanisms could be more or less effective than each other?

A. I am not quite sure what you mean by more effective.

I would say that they can lead to a different speed of pass-through.

Q. I am suggesting they potentially lead to a different rate of pass-on. Because if they are different mechanisms, why would they lead to the same rate of pass-on?

A. Well, I think the -- I mean, it depends on the situation, so one has to make some assumptions here. If you are in a situation where firms are operating, for example, in a very competitive industry with very low margins, then you would expect the cost to be passed through. Even if it is a fixed cost, and even if it takes a while for it to be passed through, you would expect it to be passed through, and therefore, for that reason, in that situation, you would still expect to see a high level of pass-on, even if it is a fixed cost, and even if it takes time for that to feed through.

Q. But given the calculations you have produced show significantly different rates of pass-on between different sectors, I am suggesting to you it is likely to follow as well that where you have different mechanisms for pass-on, they will not necessarily produce exactly the same pass-on rate?

A. Well, so I agree with your starting point, that the pass-on rates that I estimate vary between different sectors. You are now sort of speculating as to why that difference is, and you are saying, well, maybe that difference is explained by different mechanisms, and, yes, that is a possibility. Of course, there are other possibilities that might explain those differences in pass-on rates.

Q. But you accept it is possible that simply different mechanisms operate to pass on different percentages of cost?

A. I think it is interrelated with things like the level of competition. So if the level of competition varies between these industries, then that might mean that the mechanism has a different outcome in terms of the level of pass-on. So I think it is not just the mechanism, I think you need to be taking account of other factors that might vary between sectors.

Q. If we go to paragraph 2.91 of your first statement, your thirteenth {RC-F/10/54}. This is one of the few sections in your report -- we will look at a couple of others -- where you do actually consider some kind of material in relation to qualitative evidence about how merchants treated MSCs in their accounting or pricing, and I want to look at the three bits you cite.

Firstly, you cite a statement from the group treasurer of Tesco about what Tesco does in relation to credit card handling costs. Why do you refer to that statement from Tesco and not what was said by *Sainsbury's* in terms of denying that it recovered MSCs through its prices, and, of course, the Tribunal's finding in *Sainsbury's* that the level of pass-on was unknown and unknowable?

A. Well, I have referred here to the -- what I am doing is I am providing some examples of where merchants do treat the MSC in this way, and so this quote from Tesco is an example to show that some merchants do treat the MSC in this way.

Q. Well, you do not -- you are not talking about it being "some" merchants here, you are saying:

"... as they indicate that merchants did consider MSCs in their pricing policies."

What I am putting to you is essentially you only cite bits of evidence that are supportive of the idea that merchants do; not the other material, including the statements of various witnesses in these proceedings, which suggest the opposite?

A. Yes, I am not sure what other evidence you are referring to, but I am just saying: here are some examples of what some merchants have said, which, you know -- and these examples suggest that some merchants do treat the MSC in this way.

Q. Essentially, what you do is you are selectively quoting bits that support the idea that merchants do, not material, for example, like the Tribunal's finding in *Sainsbury's* which does not necessarily support the same conclusion?
A. Okay, well, you might have to take me to the other evidence that you are referring to, but all I am saying is I am just saying here are some examples of merchants who treat the MSC in this way.
Q. Now, if we go to paragraph 2.112 of your report {RC-F/10/62}, you refer to the fact that -- and it is based on the EC Guidelines there -- the size of a cost may have an impact on when it is passed on, which is something you acknowledge, that the size of the cost can have an impact on latency.
A. Yes.
Q. Then you conclude at paragraph 2.114, you talk about:
"The MSC is a relatively small component of merchants' total costs."
It says at paragraph 2.115:
"However, that evidently does not imply that MSCs have been negligible for retailers. MSCs have been substantial in relation to merchants' net margins."
Then you talk about -- then you identify three pieces of material you rely upon in relation to that.

First, in relation to subparagraph (a), you compare the operating margins of the large supermarkets and grocery retailers in the UK in 2008, and then if we go over the page, you compare that to credit card MSCs in Europe in 2000 to 2001.

So if we go back over the page to the operating margins. So that is operating margins. Operating margins are after deducting the cost of goods and operating expenses, those would be the numbers after categories of costs which will include payment costs, will they not, of various kinds?

A. Yes.

Q. So when you are comparing operating margins to MSCs, what you are also doing is ignoring the proportion of transactions that take place in credit cards, are you not? Because if you have a small cost that is only incurred on a small percentage of transactions, the overall cost of the business is going to be rather small, is it not?

A. Yes.

Q. So that comparison there is essentially meaningless without knowing the proportion of transactions?

A. Well, I would not say it is meaningless, but I would agree with you that a better comparison would have taken account of the proportion of transactions that are -- on which the fee is charged.

Q. If we go down to the next point you make, subparagraph (b), over the page {RC-F/10/63}, you refer to some evidence, and some of it is in yellow, and it seems to be both the identity of the merchant and the numbers are confidential, so we will try not to refer to those.

But you see some evidence that Mr Percival has given in relation to the scale of the MSCs compared to that business's total revenues. Given the nature of the business, I think we can say it is within the hotel/gaming category, because that bit is not blocked out. But given the nature of that business, you would expect it to have high levels of commercial card and inter-regional transactions, would you not? It is going to be very business and international traveller-focused?

A. Yes.

Q. Commercial card MIFs and inter-regional MIFs you will be aware are significantly higher than consumer MIFs?

A. I think we are getting into the realms of speculation here. I think if the point you are making is that this is a merchant where you would expect a high proportion of transactions to be paid for using cards, then, I mean, it is speculation, but that sounds plausible to me.

Q. Also, a high proportion of transactions are taking place on expensive cards, i.e. inter-regional commercial cards which have much higher interchange fees?
A. That is possible, yes.
Q. We can see these figures are being cited for quite a recent period, more than a decade after -- almost a decade after the end of the Merricks claim period?
A. Yes.
Q. Commercial card transactions are not part of Mr Merricks' claim, are they?
A. No.
Q. Inter-regional card transactions are not part of Mr Merricks' claim?
A. Inter-regional, not intra-regional, yes.
Q. So looking at a completely different business with a large number of very expensive transactions which are outside of the scope of the Merricks claim, that tells you absolutely nothing about whether MSCs were substantial for the general run of retailers during the Merricks claim period, does it?
A. Well, I think you make a lot of assumptions and speculations there, which I am not really quite sure how much they would impact the comparison, would be my answer to your question.
Q. Well, you are not in a position to say that number has

any relevance to the general run of merchants during the Merricks claim period, are you?

A. Well, I think saying it does not have any relevance is a very strong statement to make. I think your point is just saying that one should take account of whether this merchant is representative of other merchants, and I would agree with that, but I think we are getting into the realms of speculation in terms of saying exactly what impact that would be.

Q. Then the final point you make at subparagraph (c) is you simply quote the headline rates, and, again, without knowing what percentage of transactions they apply to, that is meaningless in terms of knowing the relevance they have to margins, is it not?

A. So I would agree with you that it would be a better comparison if you actually looked at the level of card transactions, yes.

Q. Well, it is not better, it is the only one that is really relevant, is it not? Without doing that, you just have -- that data is meaningless without knowing the proportion they apply to?

A. Well, I would not say it is meaningless, but I would say it is a better comparison, yes.

Q. You also give evidence, if we go to paragraph 2.109 {RC-F/10/61}, in relation to pass-on of recurrent or one-off costs, and you say that:

"MIFs and MSCs [paragraph 2.110] have ... changed infrequently and mostly by small amounts."

Therefore you are suggesting that basically MSCs are recurrent, rather than one-off costs.

I put it to you once again: while the headline rate may not have changed a great deal, the proportion of transactions which took place certainly did, did it not?

A. The proportion of transactions will have changed, yes.

Q. Well, I mean, there are a variety of sources, potential sources, showing what the proportions, how they have changed over time, which was discussed in the hot-tub, but all of them show a very dramatic increase in payment card transactions between the early years of the Merricks claim period and today, something we all know from our own experience?

A. Well, you use the word "very dramatic". I think there seems to be some dispute about the numbers and the scale of the change, but I would agree with you that, you know, the volume of card transactions has increased over time, yes.

Q. So maybe when you are talking about a cost in 1992, it is going to be -- you know, comparing that to a cost ten, 15 years later, it is going to have gone up significantly, in general, is it not?

A. Well, again, it will have changed. Exactly how much it will have changed seems to be something that ... There is some dispute about the scale.

Q. You say at paragraph 2.68 of your report {RC-F/10/48}, you are making the point that:

"... pass-on rates for market-wide costs are higher than pass-on rates for firm-specific costs."

If we could turn up the joint experts' statement, we can see what you said about the impact of that principle in relation to card acceptance. That is {RC-K/19/31}.

You say on the right-hand side, second paragraph:

"I would, in any event, investigate the extent of card usage over the relevant period, for sectors where data are available."

Then you talk about where you might get it from.

Then under your "Top-down" heading, you say:

"If evidence shows that payment card acceptance was inconsistent across merchants ..."

Which you say you "consider unlikely".

"... estimates of pass-on of industry-wide costs may require some suitable adjustment (potentially based on theoretical considerations) before being applied to MSCs. If (as I consider more likely) card acceptance was market wide, or close to market wide, then the top-down approach would need no further adjustment."

So your position in the Joint Expert Statement was you accepted it was necessary to investigate card acceptance; yes?
A. Yes.
Q. If card acceptance was inconsistent, you thought you would need to adjust any pass-on figure that came out of it? That came out of looking simply at the pass-on of industry-wide costs?
A. Well, I say it "may require some ... adjustments".
Q. By "adjustment", you mean reduction?
A. Yes.
Q. Because then it would be -- the MSC would be a firm-specific, rather than a market-wide cost?
A. Yes.
Q. Let us see what position you take in your most recent report. If we can turn to paragraph 2.69 {RC-F/10/49}, this is dealing with the principle we have just seen in relation to market-wide versus firm-specific costs, which you see just above, and then you say:

"That might suggest that the pass-on rate would vary with the rate of card acceptance. If card acceptance ... was low, the MSC would not be a market-wide cost ... Conversely, if it was high, it would be a market-wide cost."

You set out principle.

Then at 2.70, you say:

"However, card acceptance does not generate a cost change in isolation. Instead, a card accepting retailer [incurs] higher costs on transactions paid for by cards ... at the same time becoming more competitive ... in turn gives the retailer scope to increase its [prices] in line ... Put another way, the idea ... a merchant might choose to incur the MSC cost, while its competitors do not, without being able to pass it on, makes no economic or commercial sense."

So what you are suggesting here is that even if acceptance is variable, you know, not general in this context, then retailers would still be able to pass on -- retailers who accept cards would still be able to pass on the costs of accepting cards, and that is the premise of what you are writing here, is it not?

A. Yes.

Q. Once again, Mr Coombs, what I am suggesting to you is you are not thinking about the Merricks claim period and the level of card holding and usage during that period. In today's world, where almost every consumer has a payment card in their wallet or purse, and the vast majority of retail payments were made with card, the merchant that accepts cards would undoubtedly be more attractive to consumers generally than a merchant who does not accept cards. In today's world, that is clearly right, is it not? But that is not the position in the Merricks claim period, particularly the early years. Credit cards were a much more niche product, held and used by a smaller percentage of consumers.

So I suggest to you that what you say in the first line of paragraph 2.70, so the idea that a merchant might choose to incur the MSC cost while its competitors do not, without being able to pass it on, you say it makes no economic or commercial sense; I suggest to you the reality is the other way round. The idea that the majority of consumers in that era who did not have and certainly did not use a credit card and would be willing to pay higher prices, that does not make commercial or economic sense, does it?

Sorry, that ended up being a very long question.

A. It was a very long question, and I think there were a lot of assumptions buried in the question there.

So I think the point is you have to look at this at the level of the individual merchant, and you also have to take account of the fact that merchants are making a conscious decision here as to whether they accept cards or not, and if they choose to accept cards they are going to incur a cost from doing so, and, you know, rationally you would not choose to accept a cost unless you expect to get some, you know, compensating benefit for doing so. So, therefore, if you made this choice to incur this cost, then you are going to expect that you are going to be able to recover it by passing it on. Now, that is the point.

Now, you are making some assumptions here about the fact that, you know, card usage was -- at an individual merchant level would have been lower at some point in the past than it is now, and that that somehow means that that logic does not -- did not apply in the past. I do not really follow why that would be the case. You would still be in the situation that the merchant is making a decision to accept cards, it is making a decision to incur the cost of the MSC, and it will only do so if it can actually recover that cost, and I think that is true whether a high proportion of people are paying by card or a low proportion of people are paying by card. That does not really sort of change that analysis.

Q. Okay. Let us focus upon what you say in paragraph 2.70, the third line:

"... [becoming] more attractive to consumers ... gives the retailer scope to increase its prices in line with the cost change even if its competitors do not incur the same cost change."

What I am suggesting to you is when you have a substantial proportion of consumers, and even your own numbers show the majority of transactions were not card transactions during the Merricks claim period, the idea that they will be willing to pay higher prices for a facility they do not want or use, that just simply does not make economic sense, does it?

A. Well, I think the reality is that merchants did choose to accept cards, they did choose to incur this cost, and therefore they must have done so in the knowledge that they were going to incur this cost, and that they were going to therefore have to recover this cost in some way.

So I do not really see that this change in circumstance changes the analysis. It is obviously -- I think it has been well accepted in decisions by the European Commission, and the whole premise of Mr Merricks' claim is the fact that this cost was not purely borne by the people who paid with card; the cost was sort of smeared across everybody who made purchases in these shops. So even if people were not using cards to make the purchase, they incurred some of the cost that was incurred by the merchant.

So I think you seem to be suggesting that for some reason that would not be the case and that the merchant would not be able to increase prices to customers who were not paying by card, but the reality is that merchants did incur this cost, and my understanding is that throughout much of Mr Merricks' claim period they were not allowed to surcharge, and even when they were allowed to surcharge, most merchants did not. Most merchants increased the price to everyone. That seems to be the situation, as I understand it.

Q. So you said the premise of Mr Merricks' case, and that is just what Mr Merricks is arguing. We are here to test how right that premise is.

A. Yes, but I also said that my understanding is that it is true that merchants did not surcharge very often, if at all, during Mr Merricks' claim period, and therefore the reality was that the cost was borne by all consumers. That is my understanding of the facts.

Q. I am questioning you about paragraph 2.70 where you try to explain how this could happen. There are obviously two options. The merchant could decide simply to absorb the cost, because it thinks it is beneficial in terms of increasing the number of sales. So pass-on is not an absolute given for every cost, you can absorb it and make a slightly lower margin and be happy with that.

But you are suggesting that the mechanism you are identifying here is that by accepting credit cards with those additional costs, it gives the retailer scope to increase its prices generally in line with that cost change, so not surcharging, general price increases, and I am suggesting to you that simply does not make sense in a world where a large proportion of your consumers are not using credit cards, do not have them. Why would they be willing to pay more for a facility they do not want or need?

A. Well, I am saying that the merchant -- the merchant is making a decision here, and it is presumably balancing the fact that, okay, some customers are not benefiting from the card facility and will incur higher prices, but it will also have other customers who will benefit and will be willing to pay the higher price, and it has to sort of balance these effects when it is making a decision.

So I think you are sort of highlighting one side of the balance, and I am saying, well, actually there is another side of the balance which is that the merchant will benefit, and some of its customers will benefit, and it takes both of those effects into consideration when it is making this decision to accept cards.

Q. I am not disagreeing with you or challenging what you say about how a merchant will think about it, I am challenging your reasoning which suggests -- what you say is that doing so gives the retailer scope to increase its prices, because that ... I mean, this is the logic of your argument that says it does not matter if these were firm-specific costs, because giving that facility will give that firm the ability to increase its prices, and you are answering me in relation to something completely different.

There is no reason why customers generally will be willing to pay higher prices for a credit card acceptance when they are not holding or using credit cards.

A. Well, I am saying that the decision here is not just about the consumers that you are talking about, it is both sets of consumers. It is about those who are not paying by card and those who are paying by card, and that is what the merchant is thinking about, and if they are deciding that they are going to incur this cost, they must expect that they are going to be able to recover it, and for that reason they are taking account of the effect on both sets of consumers, not just on one set of consumers.

Q. But when you say "recover it", though, that is said, they can recover it simply by making a slightly smaller margin.

Your evidence here is they will increase the prices.

We are talking about pass-on here. So I am just suggesting to you that your reasoning for saying they will be able to increase their prices simply does not make commercial sense.

A. Well, I think it does make commercial sense. If they -- they are gaining an advantage over their competitors because they are able to attract customers who want to pay by card, which are customers who their competitors will find it more difficult to compete for, and therefore that gives them an ability to charge a higher price.

Q. But, I mean, that logic will presumably apply to all firm-specific costs. No firm is ever going to incur a cost unless it thinks there is some advantage to it or some need to do so.

A. Well, no, the point is that -- and it is a very good point, so I am glad you raised it. So, you know, there are two type of cost increases that a firm can face. One is sort of an exogenous cost increase, so its supplier increases the cost of an input and the merchant is then faced with this cost increase. So they have no choice about that; they just find that the cost of some input has gone up and they face that higher cost, and obviously ideally they would want to pass it on, but if they are the only firm in the market that has incurred this cost increase, then they are going to find it difficult to do so, because their competitors have not incurred the same cost. So that is the sort of simple way that we think about this distinction between firm-specific and merchant-specific cost.

The point I am making is that the MSC is not that type of cost, it is not something exogenous that just happens to the merchant. The merchant has made a conscious decision: I am going to choose to accept cards, I am going to choose to incur the MSC. That is why this situation is different from the situation you are describing, Mr Cook, where a firm just faces some exogenous cost increase.

Q. But I still come back to the question, which is -- I will put it for one last time -- there is no way a retailer can charge a higher price to customers who do not want to (inaudible) that facility, and when they -- when you are in a market that has a lot of them, that is simply going to be a part of price increases, is it not?

A. Well, I disagree. As I say, I think the merchant will balance the fact that it will -- that some customers might be discouraged by that price increase, because they are suffering a price increase but not having a benefit, but it also knows that it is going to attract customers who want to pay by card if its competitors are not accepting payment by card.

Q. If we go to paragraph 2.73, which is at the bottom of the page, you refer to examples that -- of merchants who do not accept cards, and you talk about them eventually being forced to follow suit.

If we go over the page {RC-F/10/50} we can see what "eventually" means in this context. So John Lewis started accepting cards in autumn 1999, Marks & Spencer in April 2000. So they obviously felt a tipping point had been reached at that point where they were at a material competitive advantage and so started accepting credit cards. The fact they did not do so until 1999/2000, eight years into the Merricks claim period, shows they did not feel it was commercially necessary for that first eight-year period.

So I suggest to you it is quite clear there is not some situation that merchants are forced into it rapidly; the "eventually" can take a considerable period of time?

A. Well, I would interpret the evidence differently. I would interpret the evidence as showing that, you know, two relatively large retail chains with, you know, strong brands, were not able to hold out, that they found they did need to start accepting cards because that is what their competitors were doing.

So I think this illustrates the point that it is very difficult for a merchant to continue to not accept cards if their competitors are doing so.

Q. Well, clearly not that difficult in the sense they did not do it up until that period of time when many of their competitors had been doing so for years beforehand?

A. But -- well, we do not actually know exactly, you know, at what point their competitors started accepting cards. We do not actually have evidence of that.

But I think the point I am just making is the fact that they did change their policy shows that clearly they felt that they did have to start accepting cards because their competitors were doing so.

Q. At paragraph 2.80 you say, page 51 {RC-F/10/51}, you would expect in a market where some merchants accept cards, card acceptance would be high, and you proceed on that basis, so it is an assumption in the absence of data on card acceptance rates. I suggest to you that the reality is you simply do not have a basis for that assumption that there may well be an extended period of time where merchants -- simply it is not an obvious choice, some merchants take one view, other merchants take another, and so you cannot proceed on the assumption that every sector ticks over immediately for all merchants within it?

A. Well, it is an assumption that is based on economic theory. I think economic theory would suggest you would accept this to happen because merchants who do not accept cards are going to be at a disadvantage, and therefore they will want to start accepting cards in order to not be at a competitive disadvantage.

Obviously, ideally, one would want to test this by examining the data and, you know, Mr Merricks asked Mastercard whether it had data that would allow us to test this proposition. Unfortunately, Mastercard did not have data that would allow us to do so. So we are not able to test the proposition, that is correct, but it does not come from nowhere, it is, you know, based on economic principles.

Q. But I suggest to you the economic principle here is the reality is if you have a relatively small proportion of consumers holding and wanting to use cards, then, you know, the economic disadvantage of not accepting them is rather more limited than it would be in a world where there are a lot of consumers holding and using cards?

A. Well, I suppose there is a threshold question there. Your question implies that there is some level, where the level of card usage is so small that nobody really cares about people who use cards, and, you know, I am not quite sure what that threshold is. You know, if it was some small fraction of 1 percentage, then probably you are right, but I am not really quite sure what the threshold would be where you would distinguish between those two situations.

Q. But -- I mean, you said you do not know where the threshold is, but below the threshold you may get some merchants accepting and some merchants not?

A. It is possible, if the level of card usage was extremely small, I agree that there must be some point at which that is the case.

Q. Now, you acknowledge in your expert report that one of the factors that can impact pass-on rates is the intensity of competition in a market, and you look at this at paragraph 2.25 and onwards of your report by reference to a dataset compiled by Professor Damodaran of New York University. That is -- if we could go there, that is page 32 {RC-F/10/32}. You call that the Damodaran data.

To be clear in relation to this data, the main set of data you are looking at, you say, does not allow you to isolate UK-only net margins; correct?

A. Yes.

Q. It is a European dataset and it relates only to the period from 2011 onwards, so after the end of the

Merricks claim period?

A. Yes.

Q. It is 2011 to 2022. So it is data for the wrong period and looking at Europe generally and not the UK. That is fair, is it not?

A. Well, I test to see whether those issues matter. So I test to see whether I find any sort of difference between the margins of claimants in this case and the data from this dataset, and I also test what happens when you look at an earlier period based on US data. Then I make a comparison to see whether the US data for the period that we have both US and European data, whether it follows the same trend, and I find it does follow the same trend.

Q. Well, we will come and look at -- you are saying the US. At the moment, the European data. There is simply no basis to assume that what the position was in 2011 to 2022 was the same as it was in the '90s, the 2010s, and certainly not the same in relation to the UK, not least given the sort of radically different retail environment you get where things like internet shopping have come along that simply were not present in the early part of that period and very much are central in the period you are talking about?

A. No, I disagree. I think that the point I have just made is that those are obvious sort of issues with this data, and so therefore I actually tested it to see whether those -- whether that mattered, and I found that actually there was not a systematic difference between the margins that you found from the claimants in this case and this dataset, and that when you looked at the pattern over time from the US data, which follows the same pattern as the European data, you did not find that that was a problem.

So I disagree, and I think that I have addressed both of those problems.

Q. Let us look at what you do in relation to the European data. If we go to table 3 at page 34 {RC-F/10/34}. So this is the table which highlights the classification of segments in the Damodaran data, and what you do is you highlight in bold those sectors you classify as retail, and then you analyse net margins for those sectors.

I suggest to you what you have done here is adopted a much narrower approach to what constitutes retail than you use elsewhere in your report and much narrower than the sectors that are relavant to the Merricks claim period. So that is the proposition I am putting to you.

If we start off just by looking -- well, firstly, you define retail in your main report as "all businesses that provide goods and services to consumers". But if

we look at -- start with communication services just as an easy one, you have identified just one entertainment in that which you define as retail. I suggest if you look at the others, the majority of those are sectors which provide goods or services to consumers and sectors that actually are relevant to the Merricks claim period or the Merricks claim, are they not?
A. Well, I made a judgment as to which of the sectors which appeared to me to be relevant to Mr Merricks' claim, in the sense that they were consumer-facing sectors. So I do not --
Q. If we look at that: advertising, perhaps we can say that is a different category. Broadcasting, that is going to be for consumers. Cable television, that is going to be very much consumers, is it not? Internet software and services, consumers. Publishing and newspapers, very much consumers. Software (entertainment), consumers. Telecom (wireless), consumers. That is something you analyse. Telecom services.
So looking at those, with the exception of advertising, eight out of the nine, rather than the one out of the nine, are retail sectors in the way that is relevant to these proceedings, are they not?
A. Well, I think the issue is that they may also be -- they may also be business-to-business sectors. So, you know,

internet software could be providing services to businesses. So, you know, I think it is a matter of judgment as to whether you think that these are, you know, more retail or more business-to-business sectors.
Q. Well, the reality is every sector probably has some commercial customers, near enough. But something like cable TV, telecoms, these are all sectors that are, you know, ones that are -- that play a role in relation to your quantification of pass-on. Because what you have done, I suggest to you, is selectively identified ones that are a much narrower category of retail than those which are actually relevant to this claim.
A. Well, I disagree. I did my best to choose those sectors which I felt were most relevant.
Q. You do a specific calculation for telecoms, do you not, in relation to Three data?
A. Mobile telecoms, yes.
Q. Yes. So these are actually ones that you actually quantify pass-on rates for?
A. Yes, but the difference is that where I analyse Three's data, I know I am dealing with consumer-facing data, and the problem here is, well, telecom services, that is not going to be purely consumer-facing, that is going to be a mixture of consumer-facing and business to business.
Q. So what I am suggesting to you is that you have

basically adopted a much narrower approach to retail than actually what is relevant to these proceedings, because --

A. I have taken what I consider to be an appropriate approach in terms of trying to identify the sectors which clearly are consumer-facing. I suppose there is an element of judge here -- judgment here, and maybe reasonable people could disagree about the choice that is made here, but that is the basis on which I made the choice.

Q. If we go to page 37, which is when we get the product, what you do in relation to this {RC-F/10/37}, you have identified your average net margins by reference to your retail and non-retail. I suggest to you that the outcome of this essentially is excluding a lot of other sectors which are likely to have higher rates and which should be part of that analysis, should they not?

A. Well, I do not -- what you are suggesting is you are suggesting that, to the extent that there are some sort of borderline cases where people might disagree about whether they should be treated as retail or not, you would say, well, they -- including those would somehow bias this comparison. But I do not think there is anything here that tells us that doing so will bias the comparison.

Q. What I am questioning is why you would exclude things
like telecoms, why would you exclude things like
software entertainment, which are clearly categories
publishing in newspapers, (inaudible) to be a lot of
consumers buying newspapers. These are all sectors
which are obviously relevant and retail sectors, are
they not?
A. Well, my point is that, you know, some of these sectors
there will be a mixture, and it is a matter of judgment
as to whether you feel they are sufficiently
consumer-facing that they should be included. I took an
approach of only including the sectors that I thought
were clearly consumer-facing.
THE CHAIRMAN: Can I just ask on that, the non-retail bars,
they are the ones that you excluded from that Table 3,
is that right?
A. Yes, so they -- yes. Maybe just to be clear, what I did
was I went through, when I identified the sectors that
I thought were clearly retail, and so those are the ones
that are the light blue in the diagram on page 37, and
then the remainder are the ones that are dark blue.
THE CHAIRMAN: So the dark blue would include things like
tobacco under consumer staples, is that right?
A. Which category was that in?
THE CHAIRMAN: Consumer staples.

A. Yes.
THE CHAIRMAN: Okay.
MR COOK: I turn then to the next bit of the analysis you do, which is 2.35. Then you say you have sought to establish the extent to which the European aggregates are representative of UK consumers, and then you have done that in relation to seven, you call, willing data providers, so these are merchant claimants in these proceedings who provided data.
Firstly, why have you -- given you are using public data, why are you looking at a subset of the claimants in these proceedings?
A. Well, because that was the data that was most easily available to me at the time.
Q. It is not, because you are looking at Bloomberg, so, you know, that is not data that is coming from them at all. You are going to public sources of data. So why you are looking just at a subset of claimants in these proceedings in these circumstances?
A. Well, because they are clearly relevant to, you know -- they are clearly within the scope of the claim here, so therefore that is why I looked at them.
Q. But the willing data providers, as has been said many times, they are not selected as representative of the merchant proceedings, still less as representative of

the sectors relevant to the Merricks claim. So looking at them just does not give you any information at all about whether margins are generally accurate, generally the same between the UK and Europe, do they?

A. Well, I think it is the -- it just seemed to me that that was capturing the sort of merchants that are relevant here.

Q. The data you refer to almost exclusively post-dates the Merricks claim period, does it not? It is 2.36. There are a couple that do overlap by a few years, but it is almost entirely post-dating the Merricks claim period.

A. Well, it is the data that was available and that I could use for this comparison.

Q. Having limited yourself to a small number of claimants who had provided data in these proceedings, even though you are using public data for this?

A. Well --

Q. It is not a very sensible way of proceeding, is it?

A. I did not choose these merchants, these merchants were chosen through a different process, and I just thought, well, if they are the merchants that are being used in these proceedings, then those are the merchants that I will look at.

Q. But you are currently looking at a different point, which is you are trying to work out whether the UK economy as a whole has similar levels of margins over time. Your suggestion is actually they have very low margins over time. So looking at those merchants is just nothing to the point, is it?

A. Well, I think it is relevant to look at them. If they are merchants that we are examining in this case, then they seem to be relevant.

Q. If we then look at the data from the Damodaran dataset for the period 1998 to 2010 which is paragraph 2.40. So given the European data is limited to 2011 onwards, you do then look at some US data, and that is in relation to the period 1998 to 2002. Then you say, in the second sentence of 2.41:

"I am not aware of any evidence suggesting fundamental differences between the evolutions of retail competitiveness in Europe and the US."

You say you are not aware of any evidence. I mean, you are not aware of any -- until you carry out any analysis, you are not aware of any evidence either way, are you?

A. Well, if we go sort of over the page to page 40 and look at the graph, Figure 2 {RC-F/10/40}, if we can do that, please. So this is comparing the European data with the US data, and the point is that the European data only starts in 2011, so that is why I am also looking at the

US data. The point is that if you look at the period where the two overlap, you find that the European and the US data follow each other very closely in terms of the pattern of increases and decreases, so I think that seems to suggest that there is a great deal of similarity between what you find in the US data and the European data.

Q. Well, Mr Coombs, looking at that, there is not a great deal of similarity between them. There might be some similar ups and downs, but with a very big gap between the two sets of data, with the exception of the pandemic which seems to have basically hit everybody equally hard.

A. Yes, but the point we are looking at here is we are not comparing the level, we are comparing the trend over time, and the trend over time moves very closely together.

Q. In relation to the US, you are talking about businesses operating in very different geographies, with different regulatory regimes, catering to potentially very different customer preferences. You really cannot draw any conclusions about margins in the US and what that means for margins in the UK, can you?

A. Well, you are sort of speculating, Mr Cook, based on the factors that you are asserting there. What I am doing is I am looking at the data, and the data shows that actually they do move very closely together.

Q. In relation to the period 2011 onwards?

A. In relation to the period when the datasets overlap.

Q. But once again you are still using the sectorisation, which we have already seen, which I have suggested to you is flawed. We are just looking at the ones that you identified in bold in the previous table we have looked at.

A. Well, I am looking at the sectors which I used in the comparison.

PROFESSOR WATERSON: Can I just ask: when you say the data moved closely together, have you quantified that in terms of a correlation or is there insufficient data to do that?

A. There is insufficient data to do that. So, unfortunately, all I can really do is plot and look at the graph.

PROFESSOR WATERSON: Thank you.

MR COOK: We are still looking at data here which does not address the first six years of the Merricks claim period?

A. Yes.

Q. Just looking at this, the reality is that there is simply no material here which gives you any information on what net margins were likely in the UK in the Merricks claim period?

A. Well, I would obviously disagree with that. So, you know, there are challenges in terms of using this data, so there were certain assumptions I had to make, but I did not just blindly make those assumptions, I made those assumptions and then I tested those assumptions. Based on my review of the data, I think those assumptions are valid, and therefore I think this data is informative.

Q. Can you go to Table 6 which is on page 39 {RC-F/10/39}.

THE CHAIRMAN: Mr Cook, we need to take a break at a convenient time.

MR COOK: I have two minutes left on this, sir, and then that would be a convenient moment.

THE CHAIRMAN: Okay.

MR COOK: Thank you.

So if we look at Table 6, so this is your analysis of the selected US retail segments which we have just understood is what we are talking about here. You do analysis of average net margins for 1998 to 2010 and then average net margins from 2011 onwards, and you have a sort of including pandemic and excluding pandemic set of figures.

You do not make any similar adjustment in relation

to the global financial crisis which will be part of the end of the 1998 to 2010 period you consider. Why not?
A. Well, if you go back and you look at the -- well, sorry, I am not quite sure the point you are making. You are saying that I do not make an adjustment for the financial crisis which occurred around about 2008-2009?
Q. Yes.
A. So if you go back to the graph on page 40, you see that there is, well, a rather sort of small dip, but it is not very significant, nowhere near the size of the dip that you get from the pandemic.
Q. But it is going to have an impact on businesses?
A. Well, judging by the graph, the impact looks to be very small.
Q. But, again, this is simply just US data, is it not?
A. Sorry?
Q. Again, this is simply just US data, is it not?
A. Well, I think we have already covered the point about the similarity between the US and European data.
MR COOK: Thank you, sir. I am moving on.
THE CHAIRMAN: All right. We will have a ten-minute break.
(11.46 am)
(Short Break)
(11.56 am)
THE CHAIRMAN: Yes, Mr Cook.

MR COOK: Mr Coombs, the other piece of analysis you do in relation to net margins is based on the Office of National Statistics' supply and use tables, the SUT data, and we see the results of that analysis in Figures 3 and 4 on pages 42 and 43 {RC-F/10/42-43}. Can we have both pages up.

Now, my understanding from your report is that you have calculated the retail mark-ups here differently for the two graphs, that you do it differently for the goods sector and the services sector. That is right, is it not?

A. Yes.

Q. What I am going to do is try to just unpack, if I can, what I think you have done in relation to the goods sector first, which is the more complicated of the two, and that relates to the four goods sectors you identify there.

Now, my understanding is the SUT data provides a distributor's trading margin for each of those sectors. Is that right?

A. Yes.

Q. So there is a distributor trading margin for the furniture sector, for example. Essentially, that distributor trading margin is the difference between sort of the basic cost of the product and the final revenue achieved by retailers. Is that right?

A. Yes.

Q. So effectively it covers the cost and margin of the supply chain including retailers, so distributors and retailers?

A. Yes.

Q. Okay. So it is just the terminology of "distributor trading margin" might make you think it is people sort of in the wholesale sector bit of it, but it is all the stages including retail.

Now, I understand what you have then done is you have looked at the retail economy-wide costs and profit margins of wholesalers and the retail economy-wide costs and profit margins of retailers and used those economy-wide figures to try and work out sort of the economy-wide mark-up that retailers achieve. Is that a fair summary again?

A. Yes.

Q. Thank you. So the end result of that might be you say economy-wide, it looks like retailers achieve a 10% -- basically they make 10% of that margin. That is sort of the outcome you are getting to, is it not?

A. Yes.

Q. Then having worked out this economy-wide 10% figure, you go back and apply that to the distributor trade margin

for, say, the furniture sector and say that is the retail and mark-up for the furniture sector, and that is the process you get to, and that is how you come to the numbers that are illustrated in the graph, Figure 3, is it not?
A. Yes.
Q. The problem I put to you with that approach is you are using economy-wide numbers when different products have different supply chains with different competitive conditions at different stages of those supply chains, and that is fair, is it not?
A. Yes. Well, it is an assumption or it is a simplification that you have to make in order to be able to produce these estimates, yes.
Q. Well, you say a simplification; but the reality is what you are doing is using an economy-wide average when actually retailers and distributors in different sectors will have different splits of costs and margins from retailers and distributors in other sectors, will they not?
A. Yes.
Q. So supply chains also evolve over time. So retailers and distributors in one sector might have one particular split, and then ten years, 15 years later it can be completely different as supply chains change and big

companies enter the market, etc. Would you agree with that?

A. Yes.

Q. So I suggest that applying an economy-wide average to try and work out what the mark-up is in individual sectors, the reality is it is just simply not informative, because there is so much uncertainty built into that kind of process that, you know, there is just no way it is going to disentangle how the actual margins of an individual sector may have changed over time?

A. Well, I think you are exaggerating the impact of, you know, one assumption that is made in these calculations. So it is a simplifying assumption that one has to make in order to make these calculations, but then you have to sort of ask yourself: well, you know, what impact is that going to have? Obviously it, you know, depends on the extent to which the numbers -- the numbers actually vary across the sectors, and more importantly, the extent to which the trend varies across the sectors. Because what we are actually comparing here is we are not comparing the sectors with each other; what we are looking at is how things change over time.

So it is not so much the difference between the sectors that might be affecting anything; the question is whether those differences change over time, and it is only if those differences change over time that it would affect this comparison.

Q. Yes, but the point being is by looking at an economy-wide average, you have no way of knowing what has happened to the supply chains for food and drink, and whether they have become slimmer over time, and therefore retailers are making more or less margin in that process or not?

A. Well, I think the comparison is still informative. I agree that it is based on that simplifying assumption. As I said, that simplifying assumption only matters if these differences change over time, and for that reason I think it is relevant to look at it. I mean, the reality is that, you know, we have just talked about the Damodaran data and, you know, there are limitations with using that. As I say, I had to make various assumptions, I think those assumptions turned out to be valid assumptions to make and, you know, the question is, well, what evidence do we have?

So -- and I think the point you are making, Mr Cook, is that, well, there are imperfections in the evidence, but the question is does one look at imperfect evidence or does one not look at any evidence at all?

So there may be imperfections here, but it is the best evidence I could find in order to make these

comparisons.
Q. The problem is you started that by saying: it is only a problem if there are changes over time. But that is essentially the fundamental question which these graphs are meant to show, is are there changes over time. But that is the crux of what your simplifying approach removes; you do not have any data on how it has changed over time?
A. Well, no, I do not think that is quite right. Because it is not how do the different sectors change over time, what I am looking at is the picture across the UK retail economy over time, not the -- I am not trying to, you know, disentangle differences between different sectors in this graph, what I am trying to do is look at the picture across the UK retail economy as a whole.
Q. So I do not understand, because you are only identifying those four sectors. You are not trying to do anything to the retail economy as a whole, are you?
A. Well, between the two graphs that is what I am trying to do.
Q. But in relation to those four sectors, you have just -- you know, when you make conclusions based on -- you say the black line, food and drink, the margins have changed over time. You just do not have any data on retail and margins for food and drink at all. That is not based on

any information about their margins, is it?
A. Well, it is an estimate of those margins based on the assumption that we have discussed.
Q. Based on the assumption that the economy-wide rate is the same for every single retail business?
A. Well, as I say, what we are interested in here is the change over time. So really the assumption is about whether they have -- whether for the different sectors it has changed over time in the same way or changed over time in a different way. That is the assumption that is being made here.
Q. But that is what the graphs are trying to illustrate, is whether it has changed over time. But you fundamentally do not have information on that fact?
A. No, I think --
Q. (Overspeaking) -- business was less efficient than the average in the early '90s and is now more efficient than the average, the margins have changed as a result in whatever direction, that is just not reflected in that -- you would not see that at all in this data, would you?
A. Obviously I am not explaining myself clearly here.
So I think the point is that what we are interested in looking at here is we are trying to see has there been a change in margins over time across the UK retail

economy. That is the question here.

What I am saying is that although there is -- the data I have used uses an average across the UK retail economy and applies it to these different sectors, that should not make a difference, unless that pattern has changed differently for these different sectors over time. That is the question here.

So the fact that you are saying, well, you know, the levels might be different between sectors. Well, that is not really the relevant issue here. The relevant issue is the pattern over time, not the levels.

Q. But you do not have any data on the pattern over time for food and drink retailers, you are just simply looking at the economy-wide average. That is your source of changes over time.

A. No, it is not, because it is, as you said, combined with data from the supply and use tables for the food and drink sector. I mean, if what you just said was correct, Mr Cook, then all these lines would be identical. They are not identical, because I have applied that to the data for the individual sectors.

Q. You are applying it to something which is just the distributor margin, which all costs and margins for all sectors of the supply chain, and then just subdividing that up by reference to the economy-wide average, so you

just do not know how that sector's -- the retail margins of -- within that sector have actually shifted over time at all, do you?
A. Well, you -- what you do know is you know how that overall margin has changed in different ways across the different sectors, and then I am applying an assumption about the retail margin in order to get from there to an estimate of the retail margin.
Q. In terms of what you have done in relation to service sectors, that is figure 4, and the analysis here that you have to do is a little bit simpler, because data for net margins is directly available for at least certain sectors from the SUT data.
The problem you have here is the data does not actually always reflect the sectors you are setting out to analyse, and that is the issue, is it not? If we look then at your Figure 4, for example, we see the red line in relation to hotels.
If we can turn to paragraph 4.192 {RC-F/10/207}, page 207 of this report, what you say there is:
"I consider the data available from the SUT to be insufficient to allow me to reliably estimate the share of different costs for the hotel sector. The SUT data provides information only at a wider level of the industry which includes food services."

So you have rejected the idea the data is actually capable of being used in relation to hotels, but you are then representing it as though it is reliable for hotels in your main analysis.

A. Well, I think you are confusing two different purposes here. So the purpose in Figure 4 is, as I said, ultimately to look at how margins across the UK retail economy have changed over time. So the hotel sector in Figure 4 is defined as hotels including the sale of food and beverages. So you have the hotel, you have the restaurant in the hotel, it is all sort of combined together.

Now, the issue is that when we then get to calculating the pass-on rate for the hotel sector, we then have to distinguish between the hotel sector and the restaurant sector, and therefore, for the purpose of calculating the pass-on rate, I needed to look at a narrower sector in order to make sure I was not sort of overlapping between my hotel sector and my restaurant sector. So that was an issue in terms of calculating the pass-on rate.

I do not think that is an issue for Figure 4. I do not think it is a problem that the hotel sector here is wider than the hotel sector that I use in my pass-on calculations.

Q. Incorporating two distinct kinds of business, like hotels and restaurants, the changes may simply reflect the fact that there are more hotels and less restaurants at particular times, so a weighting effect?
A. But what I am interested in is the average. As I say, it is not so much about the individual sectors, it is about the position across the UK retail economy. The fact that it is an average does not really matter. All of these sectors, by definition, they are all averages, they are all averages across large numbers of businesses. So the fact that the hotel sector here is an average across, you know, a larger part of the business than the other definition of the hotel sector that I use for my pass-on estimate, that does not really matter.
Q. I suggest to you the reality of what you have done here is the SUT data just simply is not capable of providing the kind of analysis over time of retail and margins that you are putting forward in figures 3 and 4?
A. No, I disagree that, particularly in terms of what you have just said in terms of the hotel sector, and I think I have explained why that simply is not the case.
Q. If we go back now to paragraph 2.52 of your report {RC-F/10/44}. You say -- so this is the next section in the bit we have been looking at dealing with net

margins, and you also -- this is a further set of reasons -- and you also rely on what you describe as market commentary, and you say:

"Market commentary, in addition to highlighting that the UK retail economy is characterised by narrow margins, notes that this leads to high rates of MSC pass-on."

Then you cite things from EuroCommerce, which is a European retail industry body, the British Retail Consortium and the European Retail Round Table. I mean, these are all submissions to one regulator or another basically asking the regulator to do something about interchange fees, are they not?

A. Yes.

Q. Now, all three of those organisations represent quite narrow aspects of the retail economy, and it is much narrower than the sectors you are dealing with in your report. They do not tend to have members that are utilities, travel, sectors like that, do they?

A. Well, I would not say they are much narrower. I think the point is that these are sort of high street retail businesses. So, you know, the British Retail Consortium represents shops that you would find on the high street.

Q. Fine. 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. Is there really much value you can place on it?

A. Well, it is what it is. I set out that these are the views that have been expressed by these organisations and I explain the context in which they have said them.

Q. You do not mention the fact that while retail and pressure groups like to argue that there has been damage to consumers, every time the pass-on defence is raised against a retailer, that retailer says: well, we do not pass it on.

I mean, that is a sort of fundamental dichotomy between what they say when they are trying to persuade retailers to act versus what they say when it might reduce their damages.

A. Well, I think that is a question for the retailers.

Q. But why are you quoting sort of one side of what they have a said and not the other side, which says quite the reverse?

A. Well, I am quoting what they have said in these contexts and I explain the context in which they have said it.

Q. I mean, quoting some statements from pressure groups, unevidenced, unanalysed, does not allow you to have --

it does not really provide any support at all for your suggestion about net margins, does it?
A. I think you are picking on one paragraph in the report which you have to see in the context of, you know, all the evidence that we have been discussing previously and all the other evidence in the report, so, I mean, this is what it is.
Q. Mr Coombs, what seems to happen consistently is you quote the bits which help support the high pass-on case but not anything which goes against that picture. That is what one sees, is it not?
A. Well, I am just saying that this is what these organisations have said in this context.
Q. But each time you quote the bits that -- you have gone out and you try to find the bits that help the story you want to put forward, high pass-on; you are not setting forward for the Tribunal the range of views that exist out there and whether it supports or not what you are putting forward?
A. Well, I am putting forward -- I am just setting out that this is what these organisations have said in, you know, a context that is relevant to this case.
Q. You are only looking at the bits that help you?
A. Well, no, I am just saying that this is what these organisations have said.

Q. The next paragraph, 2.53, you refer to some material from the *Sainsbury's* case {RFC/10/44}. Firstly, that was just in relation to *Sainsbury's* supermarket, was it not, so it was not in relation to the retail economy at large at all, it was *Sainsbury's* only. You are aware of that?
A. Yes.
Q. Again, if we look at it and we go over the page {RC-F/10/45}, you quote Mastercard's argument and, again, you do not make any reference to the fact that those arguments were rejected by the Tribunal. Why not?
A. Well, I am just setting out that this is what experts -- this is what the experts said in these cases.
Q. Well, equally, there was an expert for *Sainsbury's* that said the opposite.
A. Yes, but this is what the experts for Mastercard said.
Q. But rejected. Why are you putting forward only the material which supports the case you want to advance?
A. Well, I am putting forward, you know, evidence which I think is relevant. Given that, you know, Mastercard is, you know, the defendant in this case, I think it is relevant to look at what the experts for Mastercard have said.
Q. Mr Coombs, I am now going to turn to your sector analysis, and you have broken your analysis down into 12

sectors. Just to be clear, in terms of that breakdown, that simply has been done based on the card expenditure data that is available, is it not? The card expenditure data is broken down into those sectors, I appreciate there is a sort of historic issue in relation to a couple of them, but you have simply taken the breakdown that was publicised on payment card usage and used that split, have you not?

A. Well, it is necessary to do that because I am trying to calculate a UK-wide pass-on rate, so therefore I have to take the sector pass-on rates and I have to multiply them by weights in order to calculate a weighted average pass-on rate for the UK economy.

So the question then is: well, where do I get data on those weights from? The only data I could find is data from these card payment organisations. It is the only data I could find which covered the Merricks claim period, and so for that reason, if I am going to use their weights, I have to use their sector definitions, and that is why I have used their definitions of these 12 sectors.

Q. To be clear, those are based on sort of very broad categorisations of types of business, nothing to do with whether they faced similar competitive conditions, were likely to have similar pass-on rates, those are simply broad swathes of the economy in each one?

A. Yes. Well, again, going back to the point that I have already made, ultimately what I am interested in is an average, it is an average across the whole UK economy. So the fact that these sectors are maybe wide, and a pass-on rate that you calculate for these sectors is going to be an average across the whole sector, does not really matter, because ultimately they are all going to be averaged up at the end of the calculation.

Q. What I am going to do is hand up a table which is just meant to be sort of ... It is hopefully being uploaded, but I think this might assist in terms of -- it is only meant to be just sort of a summary of the different categories, rather than being spread over hundreds of pages of Mr Coombs' report. It is a sort of checklist for the Tribunal when you come to look at these issues. (Handed)

THE CHAIRMAN: Had you sent this to the other side beforehand?

MR COOK: It has been sent this morning, sir. I have tried to make it vanilla, sir.

MR WILLIAMS: I understand when Mr Cook was on his feet we received a notification that it had been uploaded, so this is the first I am actually seeing of it.

THE CHAIRMAN: Not ideal.

MR COOK: It is just meant to be helpful checklist.
THE CHAIRMAN: Well, hopefully it will prove to be uncontentious.
MR COOK: If there is any part of it which is wrong, that is down to me getting it wrong, as opposed to -- it is trying to be a neutral document which just sets out where the -- what the numbers are and what the categories are.
THE CHAIRMAN: Okay.
MR COOK: So Mr Coombs, I will pass a copy up to you just so that you have a copy. (Handed)
So what I am going to do, Mr Coombs, is start with the sectors you analysed purely by reference to public data, which are the first six in this table, and I have done them on the basis of size, so we are dealing with the biggest one of those six first, which is food and drink. Your number for that is 97% pass-on, which we see in the penultimate column on the right-hand side, with the weighting you apply to it in the final column.
So I am going to start by asking in relation to the food and drink sector. Food and drink, so that is merchants who sell food and drink for consumption elsewhere, so it is supermarkets, bakers, not restaurants?
A. Yes.

Q. Now, this is addressed in your thirteenth report, your first report, and we can pick this up at paragraph 4.126 which is I think page {RC-F/10/178} -- no, over the page, 179 {RC-F/10/179}.

So this is your food and drink sector, the analysis. You start off in a sort of familiar pattern to these. You start off by looking at previous studies in the food and drink sector which you list at Table 38, which is at page 180 {RC-F/10/180}, and these are the studies you consider to be more useful, and we see that there are, I think, five studies which either -- the first four are UK only, the fifth one, Shang and Ngo, includes the UK, and those are studies which have some UK element to them. We see that four of those relate to taxes on alcoholic beverages, and the other UK study, which is the one at the top of the page, relates to the effect of wholesale prices, i.e. COGS, on 14 retail products.

So the studies that are available only cover a very tiny proportion of the goods which make up the food and drink sector, do they not?

A. Well, I am not sure if it is a tiny proportion. It says 14 products, including food items.

Q. Do you know which products they are?

A. Not off the top of my head, no.

Q. Okay, right. They cover only, then, a proportion of goods which make up the food and drink sector. It is not in any way meant to be the entire sector?

A. It is not the entire sector, no.

Q. Those studies provide a range of results from 70 to 100% but, as you observe in your report, pass-on results tend to be particularly high for alcoholic beverages, and actually most studies relate to alcoholic beverages. That is fair, is it not?

A. Yes.

Q. Now, so that is the studies that basically are limited and largely deal with alcohol.

If we turn now to the public data that you in fact analysed, you carry out two pieces of analysis. The first one is a comparison between the producer price index for food, beverages and tobacco produced in the UK. The reference for that is 4.147 in your report {RC-F/10/194}.

So this is sort of the reason for the table. So under the column "Analysis", we can see the categories that Mr Coombs has used. So the first one is PPI, so Producer Price Index, for food, beverages and tobacco produced in the UK. Then you compare that to the CPI, Consumer Price Index, for food, alcoholic beverages and tobacco, and then you also do a second comparison which includes a composite index of costs, where you add on the AWE data, which is the Average Weekly Earnings data, for retail trade and repairs.

So those are sort of the three sets of data that you look at in this context, are they not, Mr Coombs?

In terms of PPI index, that is just UK production, not imported goods. That is right, is it not?
A. That is correct, yes.
Q. So that is essentially a partial measure of COGS, is it not, since a significant proportion of the food and drink we consume is imported into the UK?
A. So, yes, it does not capture imports, but actually in this sector domestic inputs are much larger than imports. So if we go to table 41, which is on page -- I cannot actually see the page numbers on this copy, I think it is 193 {RC-F/10/193}, you see domestic inputs are much more significant than imports in this sector.
Q. 25% or so of food and goods is imported?
A. Well, 19% is the --
Q. That is 19% of 100. So if we are looking at a denominator of what is in the food and good, we have to look at domestic inputs and importing inputs, do we not? (Pause)

So if we are talking about what percentage of food and drink is imported, we need to add up 19 -- the denominator is 19 plus 56?

A. I see. Yes, yes.
Q. So it is about 25%, very rough and ready?
A. Yes.
Q. So your PPI index is just the, call it 75%, round number, of goods which are UK domestic produced, and so that is your PPI index.
Now, in terms of -- and for the moment, I am just looking at PPI and CPI, that comparison. You suggest in your evidence in the hot-tub that this was an example where you get a "very good match" between the two indices. Do you remember saying that?
A. Yes.
Q. I want to have a look and see how they actually operate. If we go to paragraph 4.148, which is at the bottom of the page, there are what you describe as "small differences" between these two indices, and it is:
"The selected CPI index includes fresh agricultural products [which are not in the PPI]; and the ... PPI covers animal feed products [which are not included in the CPI]."
You give some figures for that.
If you turn on to the next page {RC-F/10/194}, 4.149:
"[You] estimate that the products in the CPI that are not in ..."

You say "selected CPI", but I suspect that is meant to be "selected PPI"?

A. Yes.

Q. "... about 11.7% ..."

Then if you go to 4.150, you say that about 7% -- prepared animal feed is about 7% of the CPI. So you have 11.7% of products in the CPI which are not in the PPI, and 7% of products in the PPI which are not in the CPI?

A. Yes.

Q. That is right. So immediately you have two indices that are essentially sort of 20% offset, are they not, because they include 11.7% or 7%, there is about 20% offset between them, you know, some at each end, some in CPI, not in PPI, some in PPI, not CPI?

A. Well, they are not a perfect match but they are a very close match.

Q. Let us look at footnote 652 at the bottom of the page where you break down some of the things which are not included. You identify some of the products which -- so these are ones which are in the CPI but not the PPI. Fruit, for example. Perhaps not a surprise that 94% of the consumption value is not linked to selected PPI series. So that is entire categories of products that are not produced here, so that is oranges, mangoes, things like that, that are products that are only imported. It looks like 94% of those products are imported and not part of the process. Is that right?

A. Yes.

Q. So what that also means is there are going to be differences in the weighting of the products in the two baskets as well. So the PPI is based on UK domestic production while CPI is based on food and drink purchases in the UK, so they are going to be different weightings depending on how much of it we produce here versus how much of it is eaten. Would you agree with that?

A. Yes.

Q. So let us give the example of wine. I mean, that is not one of the products you refer as to being present in the CPI and not the PPI because the UK does produce some wine, does it not? You may be aware.

So wine would figure in the PPI, but we produce a tiny little -- tell me if you do not know, but the UK produces a tiny little bit of wine, so the vast majority of all the wine we drink is imported. That would be right, would it not?

A. That may well be true, yes.

Q. So in a product -- so basically you will have almost a tiny weighting for wine in the PPI, where the CPI will have quite a substantial weighting for wine, even though technically they both figure in both indices. Is that right?

A. Well, you say have substantial weighting --

Q. Do not worry about what adjective I use to describe it. I am making the point that whatever wine percentage is in there, it is going to be a very, very small one, and much bigger in the PPI, and a much bigger one in the CPI. That kind of weighting effect will apply to any product where the majority of the product is imported rather than being UK produced. So as long as there are different percentages, all these weightings will be different?

A. Yes.

Q. So they are not just covering the same products as each other, there is also going to be quite different product mixes within them, are there not?

A. Well, there will be some differences, yes.

Q. We have seen -- we have just heard the importance of imported goods, so it is about 25%. So immediately there is that offset as well, which is that is the difference at that level between the CPI, which is all products, including that 25% imports, and the PPI, which is only the 75% produced here.

So I would suggest to you, looking at all of those, these are not small differences; there are really quite dramatic differences between these two extremely dissimilar indices that you are considering?

A. Well, I would not agree that they are dramatic differences. I think that they are small differences.

Q. Well, I mean, you are -- I mean, there is such a large percentage of products that is one and not the other, missing out of one and not the other as they are imported or not. Those are -- you know, looking at it in the whole, those are just very different indices in terms of the weighting, the value and the goods included. They are not comparable at all, are they?

A. Well, I think they are comparable. I agree that there are some differences, that they are not a perfect match. Unfortunately, you know, that is the nature often of data like this, that they are not a perfect match, but I think that they are sufficiently similar that they can be used in the analysis.

Q. So that is your first comparison. You then also produce what you describe as a "composite cost index". So that involves taking the domestic PPI index we have just discussed, which you would agree is basically a partial measure of costs, that PPI index, is it not?

A. Sorry?

Q. The PPI index is basically a partial measure of COGS,

because it does not include all of the imported goods?
A. Yes. I mean, I would view that it is a good measure, but it is not a perfect measure, no.
Q. But it arithmetically is a partial measure of COGS, is it not?
A. Yes.
Q. So you take that PPI, and then you add it to the AWE, the annual weekly earnings, for the retail trade and repairs.
So Average Weekly Earnings, I mean, that is just simply the average pay per week, is it not? That says somebody in the relevant sector -- we will come to what sector it is -- earns £500 a week on average; that is what the number is, is it not?
A. Well, to be clear, it is an index of how that wage changes over time.
Q. All we are looking at is just average pay, how that changes over time?
A. Yes.
Q. It is not a number that is given as any indication of how changes in the quantity and type of labour employed in the relevant sector, how that happens, is it?
I mean, if you -- there might be a very small effect in the type of labour changes, but in terms of the quantity it is just something that is not going to be -- we do

not know how quantity and types of labour change from looking at that average weekly pay, do we?
A. So it is -- well, it is the level of pay. I mean, if you go back to Table 41 on page 193 {RC-F/10/193}, you see that the proportion of wages in this sector does not really change very much over time. It is relatively stable.
Q. It is a proportion of turnover. But when you are looking at your average weekly pay, you are not -- that is not telling us anything about how the ratio of number of staff employed is changing over time, is it?
A. No. I mean, I am not really quite sure what you are getting at here, but it is obviously an average measure of wages.
Q. The AWE measure you are using covers a very broad sector. So this is all retail trade and also repairs. So that is effectively for anybody employed in almost any form of high street shop, that is going to be measured in -- that will be part of that measure, is it not?
A. That is right, yes.
Q. It is also going to involve people engaged in repairs, so somebody who is a mechanic who fixes a car, that is also going to be included in that average weekly repair -- average weekly pay measure?

A. Yes.

Q. So it is not even a measure of the average weekly pay of a food and drink sector employee, is it?

A. Well, I think it raises the question as to what is the relevant labour market here. So is it that people who work in supermarkets are people who only ever work in supermarkets, or when supermarkets are recruiting people, are they recruiting from a wider pool of people who might work in supermarkets or might be willing to work in other types of retail outlets.

It seems to me quite plausible that people who work in supermarkets also potentially might consider working on other types of retail outlets as well, and therefore the labour market is going to be broader than just supermarkets.

Q. Yes, but the problem with that is this is an average that encompasses people who are skilled, semi-skilled, people doing Saturday jobs at 16, you know, and the point I am making to you is what you have, is that for the entire retail and repair sectors across the entire economy? Nothing that tells us anything to do with where the average pay of the actual food and drink sector employees falls within that. It might be they are employing a lot of 16-year olds to stack shelves at very low rates, and this number simply does not tell us

anything about that at all, does it?
A. Well, it seems to me that it is going to be, you know, a good measure of wages in this sector, because, as I say, this is the wider labour market from which people are drawn who work in this sector. So I think the fact that it is an average across that labour market, I do not see that as being a problem.
Q. It is going to include people like, you know, skilled mechanics who might be earning significantly more than a 16-year old stacking shelves, so it is including a whole lot of other sectors which might have completely different kind of patterns of who they employ than a food and drink supermarket?
A. Well, I doubt that the differences are going to be as great as you are suggesting, Mr Cook. I think one point to bear in mind is that the reason I use this index is because it is the most disaggregated index that the Office for National Statistics produces, it does not produce a more detailed index, and I suppose you have to ask the question, well, why is that? Presumably they do not make these decisions at random. They presumably think this is a meaningful index that represents this labour market.
Q. Well, the fact there is an index produced does not tell it is useful for our purposes.

A. Well, I think it is -- since it covers the sector that we are looking at, I think it is probably useful for our purposes.
Q. You say "since it covers"; basically it covers the vast majority of the sectors in total, does it not?
A. Yes, well, so a lot of this analysis is looking at retail sectors where I would expect that the employees are drawn from the same labour market, yes.
Q. The other problem with using pay data in your analysis is you can no longer have an expectation about the direction of causality here, can you? If you are looking at COGS, you can reasonably expect to find, if there was a relationship, that its costs will have an impact on prices. But with labour costs, the increases in prices will also impact on pay rates, will they not?
A. Sorry, the increase in prices will impact on ...?
Q. Pay rates. If inflation in the economy means everything is more expensive, then it is likely that employees are going to seek higher rates of pay and they will have to be paid higher rates of pay. So prices impact on average rates of pay, do they not?
A. Yes.
Q. So what you have is a relationship which is not then: do costs feed into prices; you have a relationship which is: prices have an impact on labour rates. That exists

as well?

A. Yes, but I think the -- well, so theoretically that could be the case, but then you have to think about the way that the econometric model is structured, because the econometric model is not just contemporaneous, it is also looking at the relationship between costs and wages today and prices in the future, and I think -- you know, I would argue, well, in that sense, the causation will be that costs and wages today are affecting prices in the future, it is not that prices in the future are affecting costs and wages today.

PROFESSOR WATERSON: Are you saying there are lags built into the analysis?

A. Yes. I mean, effectively it is lags. It is not -- it is a -- yes, it is a distributed lag model, so effectively it is looking at lags, yes.

MR COOK: But in terms of pay rates, people were also aware of prices going up, so they will be taking account of what prices will be in the future, not just historic prices, will they? So there is an element that you want your pay rates to reflect what you will need to buy next month and the month after that?

A. I think we are getting into the realms of speculation here. I would think people are more focused on their experience of what is happening today and recently,

rather than speculating about what might happen in the future.
Q. But the difference is, you would agree, that prices have an impact on pay rates in general?
A. Yes, but I think the way the model is constructed is that that is unlikely to bias the results.
Q. Let us look at the analysis you actually do in relation to the two measures of costs that you ... and I want to look at some of the modelling choices you make here, which is at paragraph 4.161, page 198 {RC-F/10/198}.
4.161, at the top of the page, explains some of the choices you make. So at subparagraph (c), you explain that you do not use a time trend for your composite cost measure but you do use a time trend for your domestic PPI-only analysis. I mean, given you are analysing essentially the same thing, why are you using a time trend or not in essentially the same piece of analysis?
A. Well, so in this case, what I simply do is I test whether the time trend is statistically significant or not, and in one case it is and in the other case it is not, so I include it in the case when it is and I do not include it in the case when it is not. To be honest, it does not actually have a big impact on the results, whether or not you include the time trend for this particular sector.

Q. You say "statistically significant". That means you are 95% confident at your 5% standard level that it is having an impact?
A. Yes.
Q. But, essentially, as soon as you do multiple things, and each time you apply 95% confidence, what you are doing is multiplying errors, are you not?
A. I do not quite follow.
Q. You say, you know, the main analysis I am 95% confident, then this adjustment I am 95% confident, this adjustment I am 95% confident. That is just multiplying the uncertainty in errors, are you not?
A. That sounds like a comment on econometric analysis in general, rather than on the specific approach I am using.
Q. Well, the specific approach you are using is what makes a difference, is you are saying you are using the statistical significance to determine which of these adjustments you would make. So it is not the case that you are saying: here are the two options, I will do both; you are deciding which one to do, and only which one to do, based on that.
So you are doing rather more than standard econometrics. You are multiplying in the errors, are you not?

A. Well, okay, maybe stepping back here. I think the first thing to say is that obviously there are choices that have to be made, because there are different options, and one has to choose, you know, what one thinks is the most appropriate way to design the model. In making those choices, one of the things you look at is statistical significance. Now, it might be that you do not just look at statistical significance; you might look and say, well, what impact is this having on the results, does it lead to plausible results? You might be looking at, well, what is the economic significance of the control variable that I am including?

So it is not quite that mechanical, but I think in this case, you know, firstly, as I say, it does not actually make a big difference to the results whether or not you include the time trend. I have taken the view that, well, if it is statistically different, I include it. If it is not, I do not. That is a very standard way that people who design econometric analysis make that choice.

Q. Let us look at the next one, which is subparagraph (d) here, 4.161(d). You say you include a time dummy for the period January 2010 to December 2019 in the model. You say:

"[That is] to control for the increasing divergence between my price and costs measures seen in the above figure."

So just stopping there for a moment. So you used a time dummy for a full ten years of data?

A. Yes.

Q. That is not quite half the data, because I think you were looking at a 24-year period, or is it a 23-year period.

The effect of using a time dummy is essentially trying to exclude such part of the data which comes out which is not consistent with the prior relationship between cost and prices. Is that a fair summary?

A. Well, perhaps if we go to the figure on page 196 {RC-F/10/196} which shows what is happening here. So what you see is the relationship here between -- costs is the red line and price is the blue line, and you see that they move very closely up until about 2010, and then, after that, they diverge, and they diverge in a way that prices are moving -- are increasing more than costs are increasing.

So, you know, just looking at the graph, what you might infer is you might infer, well, pass-on is sort of close to 100% up until 2010, but then after 2010 pass-on seems to be more than 100%, that there is overshifting between costs and prices, and, you know, that is clearly a change in the relationship. Now, what I do is I control for that change in the relationship by introducing this dummy variable.

Now, what impact is that having? What is happening is it is effectively slightly reducing the estimated pass-on rate, because it is assuming that there is some external factor which is causing this divergence that starts in 2010. So it is, you know, it is a judgment, but it is a judgment which is, you know, a conservative judgment in the sense that it reduces the estimate of the pass-on rate.

Q. Okay. Look at the explanation you give. You say -- and this is the point you made in relation to subparagraph (d) we just saw, which is to deal with the increasing divergence.

But if we go back to what you say under the relevant figure, which is at paragraph 4.155 {RC-F/10/196}, you say the reverse:

"Figure 13 shows that the respective price and cost measures evolve in a very similar fashion over time [with] a very high correlation coefficient ..."

So there you are saying they evolve in a very similar fashion, and then you then say: no, I need to exclude or take account of the last ten years to control for increasing divergence.

A. Well, both of those things are true. They do move very closely together, particularly in the first period up to 2010. So both of those things are true: there is a close relationship, but there is also a divergence from 2010 onwards.

Then just to be clear, I think it might have been a slip of the tongue, Mr Cook, but I am not excluding the data from 2010 onwards, I am still including all of that data, I am just controlling for the fact that there is a different relationship.

Q. But --

THE CHAIRMAN: This is the graph that includes the time dummy, is that right?

A. No, this just the raw data, so this is before I have done any econometrics. This is just a simple graph that just plots the cost over time and the price over time -- the cost index over time and the price index over time.

THE CHAIRMAN: I see.

MR COOK: So even if there is a divergence, I mean, it may just simply be that that is a product of different pass-on rates at the different times?

A. Yes. So, as I say, it may be that therefore the approach I am taking is conservative, because it may be leading -- it leads to a lower pass-on rate than if you do not control for this. So I am making the assumption that there is some external factor here, but if it was the case simply that the pass-on rate was higher, then I am being conservative in my approach.

Q. If we turn to Ms Webster's report, which is {RC-G/13/62}. Ms Webster explains at subparagraph (b) at the top that the effect of your dummy variable is in fact to increase the upper bound estimate. She says that removing it, so not including it, decreases the pass-on elasticity estimated from 1.03 to 0.85. So this adjustment actually increases elasticity by about 20%.

A. Well, I am not quite sure exactly what Ms Webster is doing here, but, you know, you can see from the graph that the concern is that the pass-on rate may be higher in the latter period, that there may be overshifting, and that is the concern I am controlling for.

Q. Well, I mean, Ms Webster -- this is her report that was served some months ago, so you have known about this. She has run the numbers without that dummy variable and that -- and if you remove it, that reduces the pass-on estimate. So you are including a dummy variable basically which mitigates the impact of that ten-year period in a way which increases your pass-on elasticity by 20%, are you not?

A. Okay, but which -- so I have two models here. There is a model 1 and a model 2. It looks like what Ms Webster is doing is she is looking at the impact on model 1, which is the composite cost index. So that is actually what is shown on Figure 14, whereas that is not actually the model that I rely on. The model that I rely on is model 2. So this -- what Ms Webster is doing here is not actually an adjustment to the model that I rely on. It seems to be an adjustment to the other model, the one I do not rely on.

Q. Well, at the moment I am just trying to understand why you are making adjustments of this kind in circumstances -- you do not have an economic reason to think, as you would with the pandemic, that some substantive change occurred which is confusing the data, you are just deciding to move it out in a way which actually has a significant impact upon your outcomes, are you not?

A. Well, as I say, what Ms Webster is doing is she is not actually looking at the model that I rely on. So if we look at the model that I rely on, then, you know, there is a trend -- a change in the trend here which I am controlling for in order to avoid potentially overestimating the pass-on rate.

Q. But the impact upon the combined composite model is actually a 20% increase?

A. Yes, but that is not the model I have used.

Q. Now, you then test your results and conclude they are significant since they pass the bounds test at 5% and then the test for serial correlation and the heteroskedasticity. I am not sure if I am pronouncing, that correctly.

Mr Coombs, you will have seen what Ms Webster says about these kind of tests in her expert report. If we can go back in the same document to Ms Webster's reply report at page 54 {RC-G/13/54}, paragraph A.115:

"As noted in Webster 1 and in the academic literature, the available tests for stationarity and cointegration have low power and are often sensitive to the model specification chosen. The bounds test faces similar issues - the results ... are often sensitive to the specification chosen, meaning that the inclusion or exclusion of potentially relevant parameters [may] result in different conclusions about the existence of a long-run relationship ..."

She says that may or may not be a genuine difference. You fail to acknowledge the inherent uncertainty in these circumstances.

I mean, that is a fair reflection of where the academic literature is on a test like this, is it not, that it is recognised that they are low power and are very sensitive to model specifications?

A. Well, I do not actually agree with what Ms Webster says here. So the first sentence, she says:

"As noted in Webster 1 and in the academic literature, the available tests for stationarity and cointegration have low power and are often sensitive to the model specification chosen."

Then she has some references there, some footnotes, which I think are to some academic papers, which show that.

Then, after that, she then says:

"The bounds test faces similar issues ..." and so on, but the papers that she cites do not actually say that. They do not say that the bounds test faces similar issues. So this is just her assertion that the bounds test faces similar issues.

I think the point here to make is that the bounds test was developed in order to overcome those issues in order to provide a better test to use in situations where you have potentially these problems.

So I do not agree with her criticism of the bounds test here, which actually does not come from the economic literature that she cites.

Q. We will see some of the problems that arise in due course, but then if you move on to see what you are doing on food and drink. At paragraph 4.164 you convert your pass-on elasticity to pass-on rate, page 199 {RC-F/10/199}, by making two adjustments: firstly, the retailer margin and, secondly, by reference to effective VAT rate. In relation to the retailer margin, this is something you calculate through your use of the SUT tables, is it not?

A. Yes.

Q. So, again, it is based essentially on the average economy-wide split between the wholesale and retail trades. So these numbers are not reflecting actual retail margins, food and drink retailers, are they?

A. Well, it is -- but it is then applied to the data for the food and drink sector. So it is not purely an economy-wide mark-up; it is an estimate of the mark-up in the food and drink sector.

Q. But based on economy-wide numbers which you have no reason to think are particularly applicable to food and drink?

A. Well, again, there is an averaging issue here because obviously I do this across all of these different sectors. So to the extent that, you know, it might be too high for one, then it is going to be too low for the other and then that is all going to come out in the average at the end of the day.

Q. Well, it would if you were consistent and applied this

generally but actually you only apply these retailer margins within a small number of sectors, do you not?
A. Well, I apply it to wherever I am using the public data.
Q. But the public data is only part of your analysis so you cannot say that the swings and roundabouts will even out when you are actually not applying it across the economy as a whole?
A. Well, I use public data estimates for most sectors. So overall it probably does mostly even out.
Q. In terms of the VAT rate, and your answer may be the same here, you have applied an economy-wide VAT rate, but this is in the context of a sector which most food and drink, and there are exceptions for most and food drink in this context, is not VATable, is it?
A. Yes, but the same principle applies, that this is the average across the economy. I then apply it across all of these different sectors. So you could do the opposite, which is you could not apply it to the sectors and just apply it to the total, but that would be effectively doing the same thing. It is just arithmetically the same whether you apply it at the end or you apply it at the sector level.
PROFESSOR WATERSON: Actually I have a puzzle about this and perhaps you can reassure me, or not, as the case may be.
VAT is paid on the gap between -- well, the retailer

has to pay VAT on the gap between the price at which it sells and the price it which it buys.

A. Yes.

PROFESSOR WATERSON: So your formula, I am not sure that that does that, does it?

A. No. So I -- well, so what I am trying to capture, I am trying to capture the impact on the end-consumer, not the impact on the retailer. So that is why I am using the effective VAT rate that is paid by the end-consumer, rather than the VAT rate that is borne by the retailer.

PROFESSOR WATERSON: Right, okay. I will think about that.

MR COOK: Well, I had a couple of questions actually on exactly that topic, so if I deal with that now and then it might be a convenient moment to break for lunch.

In relation to that, what you are looking is to try and determine sort of the mark-up effectively, the VAT, the additional element on top of costs which comes on to reflect the price, but as a practical matter, if you are a retailer in the goods sector -- to keep it simple, food and drink sector here -- where you have or in sectors where is there is VAT applicable, if you have bought your goods with VAT included in that and then, while you notionally add VAT on, in practical terms the actual uplift you are doing in that process is very small because you recover the VAT.

So, you know, the additional element on top is going to be minimal, is it not?

A. Yes, but that is -- so I am not quite sure I understand the question. The point that you are making is you are saying that for a retailer, they -- so they purchase goods on which they pay VAT. They then charge VAT to the end-customer and they can recover the VAT that they have paid so they overall amount of VAT that they incur -- that the retailer incurs is just the VAT on the margin between the two, which is, I think, the point that Professor Waterson was making, and the point is that, well, that is relevant if what you are trying to assess is what is the impact of pass-on on the retailer. The point I am making is that what I am trying to assess is the impact on pass-on on the consumer and the consumer pays VAT on the whole lot.

Q. But if you are looking at the additional bit that is added on top of -- due to prices, for example, that is going to be -- you know, in practical terms a retailer is only adding on that additional sliver?

A. Well, but if we talk about -- well, remember what we are talking about here is we are talking about -- we are using pass-on estimate here as a proxy for pass-on of the MSC and there is no VAT on the MSC. So the -- so to the extent that the MSC is passed on, then that is a cost where, you know, the retailer is not paying VAT, but in terms of the impact that that has on the price that is paid by consumers, consumers are paying VAT so therefore there is no sort of offsetting in terms of the MSC. The MSC is zero-rated for VAT.

Q. So, to clarify, you do accept therefore that your VAT number is wrong for sort of the pass-on of costs generally, is that right?

A. If we -- yes. What I am specifically looking at is the pass-on of the MSC.

Q. So, in effect, you seem to be saying that you think pass-on of MSCs is higher than the pass-on of COGS generally?

A. No. I am just saying that the impact -- I am just trying to accurately calculate the impact of VAT on the pass-on of the MSC. So I am saying I am making an accurate calculation for the pass-on of the MSC.

Q. But you are now saying your numbers are not an accurate calculation of the impact in -- or the pass-on rates for the costs you are actually considering?

A. No. Okay, let us unpack this. So, first of all, I calculate the pass-on rate for these costs and then what I am saying is, I am saying, well, I then use that as a proxy for the pass-on of the MSC and I am saying, well, if we then consider the pass-on of the MSC, we have to include the fact that the consumer will incur not just the pass-on of the MSC but also VAT on the pass-on of the MSC. So that is what I am doing.

I suppose what you are suggesting, Mr Cook, is if we were then to take that final calculation and say this is the pass-on rate for all of the costs incurred by the retailer, no, it would not be an accurate representation of that, but that is not what I am trying to estimate here. That is not what I was instructed to do. What I was instructed to do was estimate pass-on of the MSC and that is what I am trying to calculate here.

Q. So, just to be clear, you are not suggesting that the figures you produce are an accurate representation of the pass-on rates for total costs?

A. Well, I do not like the way that you are trying to say --

Q. No, I am just trying to be clear that that is what I have understood you to say?

A. No. Well, I do not like the way that you are trying to suggest that what I have done is inaccurate. I would say that what I have done is I have accurately estimated the pass-on rate of a cost proxy for the MSC. I have then used that as a proxy for the MSC and I have then made an appropriate VAT adjustment when I then calculate what impact that is going to have in terms of pass-on of the MSC.

Now, I am agreeing with you that if you were then to take that estimate and use it in a different context, outside of what I have been instructed to do, it may well be the wrong number, but it is the right number, given the instructions that I have.

Q. Sir, I have two more questions on VAT, exciting as it is, and then we can break for lunch.

So just in terms of you using economy-wide average, firstly, you are not using these VAT numbers for all of your sectors are you?

A. So I am using it -- well, this VAT number I use for the sectors where I have public data. Where I have merchant data, the merchant data sort of reflects the VAT situation of that particular merchant as to whether, you know, some of the merchants that we have data for, VAT is charged on their products and it is included within the data and some of the merchants are zero-rated for VAT, so the merchants in the financial services sector there is no VAT, although there is insurance premium tax in the insurance sector which has to be factored in.

So I take different approaches for the public data, which is sort of aggregated across these sectors, and for the merchant data where I look at the specific situation of the merchant.

Q. Your economy-wide average is based upon total transactions in those which might be quite different from credit card transactions in those. Your weightings are wrong, are they not?
A. Well, I do not know if the weightings are wrong. I am just using the VAT -- the rate for the economy as a whole. You are suggesting that products which are purchased with credit cards might have a different mix in terms of VAT treatment compared to the economy as a whole. That is not something that I have looked into, no.
Q. But it is likely you would expect the credit card transactions will be higher in certain sectors than others?
A. I do not know whether it is likely. I have not looked into that.
PROFESSOR WATERSON: This VAT rate, this is the average across the economy, you say?
A. Yes.
PROFESSOR WATERSON: So what proportion of foods sold by supermarkets, let us say, is zero-rated?
A. So I do not know the answer to that question and, as I say, I have tried to sort of do this at a higher level. Rather than a looking at the VAT situation of a deep sector, I have just taken it at the higher level

on the basis that it will all average out across sectors at the end of the day.

PROFESSOR WATERSON: But in some sectors it will be on all the products and for food it will be on a proportion of the products?

A. Yes, that is correct.

MR COOK: I think that is VAT done for now, sir.

THE CHAIRMAN: Right. Okay. So we will adjourn now until 2 o'clock.

(1.02 pm)

(The luncheon adjournment)

(2.00 pm)

THE CHAIRMAN: Good afternoon.

MR COOK: Good afternoon, Mr Coombs. We are still with food and drink, I am afraid, and we are moving on to one of the last steps in your food and drink analysis, which is temporal extrapolation, which is step 6. This is paragraph 4.168 at page 200 of your report {RC-F/10/£200.

Having calculated your pass-on figures based on data which is 1996 to 2019, the final step you take is to consider the extent to which it is appropriate to essentially apply that result back to the Merricks claim period, which of course is 1992 to 2008. You explain at paragraph 4.168 that you do this by carrying out the same analysis but excluding the last five years of the data, so 2015 to 2019, to see if it has any impact on your analysis, and you say it has not made a tremendous difference and your results are not substantially affected.

But as we have already seen, you have -- you are using a time dummy for January 2010 to December 2019. So you are now excluding data that you have already partially eliminated by using a time dummy, are you not?

A. Well, I have not eliminated the data using --

Q. (Overspeaking) -- You have mitigated the effect by identifying -- the time dummy basically allocates the fact there is a potential factor there which is due to something else, and you use a dummy for that, do you not? So you minimise the extent to which you are relying on that data by allocating some of it to the time dummy effect?

A. Or I have controlled for whether there is some other effect that starts in 2010.

Q. So I think it is fair to say that you have essentially minimised the extent to which you rely upon that data already, so when you remove five years of it --

A. No, I would not agree with that way to describe it. What I would say is I am controlling for whether there is some effect that starts in 2010.

Q. So basically what you are doing now is you are now removing five years of data which you are already applying a control to?
A. Yes.
Q. So it is perhaps not surprising it does not have very much effect on your results?
A. I do not think that necessarily follows.
Q. In any event, what you are doing is you are looking at -- all you are doing by excluding the last five years of the data is testing whether there are differences in the pass-on rates between the period 1996 and 2014 and 1996 and 2019. So that is what you are doing, essentially?
A. Yes.
Q. Which still is not telling you very much about whether those estimates are a good estimate for a pass-on rate for '92 to 2008, because you are still looking at a whole lot of data which is post-dating that period, are you not?
A. Yes. So the issue is that obviously as you remove data from the sample, then the regression becomes less robust, the estimate becomes less precise. So there is a balance to be struck here between removing data in order to test whether there is an effect, and making sure you still have enough data to produce a reliable

estimate.
Q. Well, if we go to Ms Webster's reply report, and that is {RC-G/13/74}. So we are looking at food and drink here and --
THE CHAIRMAN: Sorry, we think you might benefit from the blinds being closed. It looks like you are looking into the sun.
MR COOK: That is very kind, sir.
THE CHAIRMAN: It is just a little bit noisy. (Pause)
PROFESSOR WATERSON: I noticed some of the barristers were sort of ...
MR COOK: Wearing dark glasses in court is frowned upon.
THE CHAIRMAN: I do not think they were expecting the sun to be out this afternoon. (Pause)
MR COOK: Figure 5. It is obviously the food and drink ones we are particularly focused on, the different food and drink, 2 and 1.
Food and drink 2 is -- that is your PPI-only measure which is the one, as you say, you rely upon in terms of putting forward a pass-on number here, and what Ms Webster has done is basically tried looking at different time periods to see what impact it makes. We see, in relation to food and drink 2, that it was said making it sort of three or four or five years does not make a tremendous difference. But when you actually

look at the Merricks claim period, which is the light blue, that brings the pass-on rate down from nearing 100% to down below 50%.

So really the amount of time data you look at does make a tremendous difference, does it not, here?

A. Yes, but it comes back to the point I just made, that in order to do that you are effectively removing half of the observations, so you will then end up with an estimate that I would argue you cannot really rely on.

Q. Well, there is an estimate -- you say that, but you have not -- did you look and see whether that was one that passed your various tests?

A. Well, what I -- as I said, you have to make a balance between how many data points you remove, and making sure that you have enough data points that you can have a reliable regression. So that is why I only removed five years.

I mean, the thing that you see here, looking at this graph, is that there is a large cluster of dots all around the same point, around my estimate, and then there are two of the dots which I think are when the largest number of data points are removed, which then results in these much lower results.

So my comment is that I am not sure that you can really rely on those estimates because they are using a much smaller sample.

Q. Well, still with your first point, which you said there is a cluster of dots there, but that is in situations where relatively small changes are being made. We see at the bottom it is up until January 1, 2006, so that is cutting off three years; January 1, 2005, cutting off four years; January 2014, cutting off five years. So those are relatively small changes in relation to a time period where you are applying a time dummy in any event.

So really the relevant change is looking at the Merricks claim period, and that does seem to -- that produces results which are significantly lower, and you are not really in a position to disagree that that is a relevant number for the Merricks claim period, even applying your own data analysis?

A. Well, it looks -- yes, but the thing that is strange is there is also -- one of the dots here is Merricks with run-off, so that is sort of the full Merricks claim period, and that one seems to be in the cluster. So it seems to be that this result is, you know, very sensitive to removing just a couple of years here, which is why, you know, it seems to me that it is unreliable to rely on an estimate where you are removing so many data points that produces a -- particularly when it produces a result which is very different from the result that you get with the Merricks period, including the run-off period.

Q. You say particularly when it gives a different result, but, I mean, that is the essence of what you are trying to do here, is find out whether a different result is justified by different time periods. So you cannot say the mere fact it gives you a different result is relevant at all, it just potentially tells you there were different pass-on rates at different time periods?

A. Well, I think you have to take a view on the quality of the analysis based on the number of observations that are being used here.

Q. Even in relation to the Merricks period, that is still 12 years of data, 13 years of data, and that is considerably more than you use for a lot of other merchants, is it not? A lot of the analysis you do by reference to individual merchant data, is it not?

A. Well, the analysis for individual merchants is very different, because there it is often that I will have actually a much larger dataset and able to do a panel data analysis.

Also I think, you know, more generally, a point that I have raised I think throughout this case, is that one of the issues with using the merchant data is that you do tend to end up with a much shorter period, and therefore in some cases you do end up with a much smaller number of observations.

Q. So how can you say that this number is unreliable merely because it produces a lower number?

A. I am not saying --

Q. Well, what reason do you have to think it is unreliable, other than you do not like it?

A. Well, I have already explained. It is to do with the fact that you are removing about half of the data points from the sample.

Q. Also looking at data which is almost exclusively -- well, exclusively in relation to Merricks' claim period?

A. Well, I have answered the question, Mr Cook.

Q. Now, you also carry out some margin analysis. That is at paragraph -- if we go back to your main report, which is {RC-F/10/202}. So this your evaluation of the evolution of retailer mark-ups for the food and drink sector. I mean, it is produced by reference to the SUT data, which I have already asked you some questions about, but for the moment, just looking at what it does show, we can see from Figure 15 that margins generally fell over the Merricks claim period from, in this sector, from 5.3% in 1996 to 3.4% in 2010, which is the numbers you quote in paragraph 4.173.

If we look down the rest of that, we can see what you say by reference to that. You say:

"This evidence may indicate this sector was less competitive in the early years of the Merricks claim period. If the market was less competitive ... my estimated pass-on rate may be overestimating the pass-on rate that applied to the earlier years of the Merricks claim period."

The first point to note in relation to that, that will be supportive of the possibility, as shown by Ms Webster's analysis, that if you look at the Merricks claim period you would get lower numbers, lower pass-on numbers?

A. For this particular sector, yes, that is exactly the point I am making.

Q. No, I was talking then about in relation to Ms Webster's analysis of the period up until the Merricks claim period. So that would be consistent with that, the fact that there was this change in margins on your analysis?

A. Sorry, I do not understand the question.

Q. So what you are addressing here is simply whether your number is too high for the early years of the Merricks claim period. I was simply relying on this and asking you that this shows that what we get from Ms Webster's shorter analysis of the Merricks claim period is a number that makes sense, because there is this change

in margins on your analysis?
A. Yes. But when she does the analysis using the full Merricks claim period, she does not find an effect at all. So her results are not really consistent with each other on this point.
Q. But -- and I think you accept this means that you may be overestimating -- well, you say you may be overestimating the pass-on rate, but you are simply not able to quantify it. So you would accept an adjustment is likely required, you just simply cannot put a number on it, is that fair?
A. Yes. Just to complete that, then when I make the overall assessment, I have a choice between two models, one that produces a higher estimate and one that produces a lower estimate, and for this reason I use the model that produces the lower estimate.
Q. But we have already seen that you were earlier trying to justify the use of the time -- use of the time dummy point, that without the time dummy your results would have produced similar results -- the two assessments would have produced similar results, so that is not a reason to choose between them.
A. Sorry, I ...
Q. I am suggesting to you -- we saw earlier that you had produced two assessments: the composite and the

PPI-only. You are saying here you used the PPI-only, but I was reminding you that there was the time dummy point which had an impact upon the combined -- the composite index. So I am saying without that adjustment, they would have been very similar numbers. So this is not being conservative in those circumstances, is it?
A. Well, it is being conservative in the sense that I am choosing the lower estimate.
Q. But a lower estimate is still based on a period up until -- sorry, a period up until 2019, rather than something which reflects the Merricks claim period itself?
A. Yes. Well, otherwise there would not be a need to make an adjustment or pick the lower estimate.
Q. Now, you conclude in paragraph 4.175, which is at page 203 {RC-F/10/203}, that you should use a pass-on estimate of 97% which is based on your domestic PPI analysis.
Now, if we go back to Table 41, which is at page 193 {RC-F/10/193}, we saw this earlier, which shows the percentage of inputs, so domestic inputs, imported inputs, wages and other costs. In relation to your preferred measure, which is domestic PPI, in practice you are just simply looking at the pass-on of the

left-hand column, which is, on average, 56.1% of costs?
A. Yes.
Q. That is essentially just a partial part of COGS, because you have not taken account of imported goods at all?
A. Well, it is a pass-on estimate based on using those costs as a proxy for other costs, yes.
Q. Am I right in saying I understand your view to be that total cost is the appropriate cost proxy for the MSC?
A. When one is using a -- estimating the impact over the long-run, yes.
Q. You are not approaching anything -- this is essentially nothing approaching total costs, you are looking at not really far off half of total costs, are you not?
A. Well, I am using the -- well, I am using the information that is available and I am using it as a proxy for total costs.
Q. Without knowing how food and drink retailers took account of things like other costs in their pricing during the Merricks claim period, this really tells us nothing about the pass-on rate for those other costs, does it?
A. Well, I would not say it tells us nothing, because I think it raises the question as to how those other costs are moving, and whether or not they might be moving in a similar pattern to domestic input costs, or

whether they are moving in a very different pattern to domestic input costs. That is the question that we do not know the answer to. So I think it depends on that as to how representative it is of those other costs.

Q. Okay. So it raises the question but you do not answer it?

A. Well, I do not know the answer to that question, no.

THE CHAIRMAN: Domestic inputs is basically COGS, is it?

A. Yes. Well, COGS will also include probably some imported inputs as well.

THE CHAIRMAN: Right.

MR COOK: If we now turn on to travel, which is the next sector I need to ask you about. Now, this is the sector which includes a number of different kinds of businesses: travel agents, we see this in Table 61 {RC-F/10/233} at page 233. We have travel agents which is the largest group, slightly below 50%, I think. Then airlines, railways, miscellaneous travel, camping grounds, we get down to quite some small ones, and buses as well.

In terms of previous studies, you identify two EU-wide studies, we see this at table 59 at page 231 {RC-F/10/231}. You identify two EU-wide studies which include the UK and, as you observe, they indicate close to 100% pass-on rate for fuel and VAT into air travel prices.

If we look at the Barbone study, though, which is the second one in this table, it indicates quite a different range of pass-on rates on an EU-wide basis depending on the form of travel in question, so there is a range there between 62% up to 117%.

A. Yes.

Q. So this is clearly not a sector which is necessarily likely to get the same results depending on what time of -- type of conveyance one is looking at, would you agree?

A. Well, yes, you get different results for different modes of transport.

Q. You also refer to the Wang et al study, which is at the bottom of the page there, which gives us a pass-on elasticity rather than an absolute pass-on rate, and you cite, when you summarise the results of this, for example at paragraph 4.276, the pass-on elasticity in relation to fuel costs to air travel fares, you see that at the top of the page. You just -- pass-on elasticities are around 0.25 of the pass-on fuel costs to air travel fares.

If we go back to Wang, though, please, over the page, we can see that that report produced -- identifies three passed on estimates or elasticity estimate: the

0.23 to 0.25 for fuel costs for airlines; 0.16 for non-fuel flight costs; and a 0.06 to 0.08 for non-fuel passenger costs.

Those are, on the face of it, firstly, indicating that different categories of costs potentially have quite different pass-on rates, obviously, they are different numbers.

A. Well, these are elasticities for different components of cost. In each of these cases the elasticity is not the same as the pass-on rate, so you have to then apply a mark-up to the cost in order to calculate the pass-on rate. So you do not really know what pass-on rate you are going to get, unless you know what the mark-up is, which we do not know in this case. So we simply do not know the --

Q. (Overspeaking) But there is a single set of analysis, so the mark-up, you are going to be applying a similar mark-up, are you not?

A. Well, no, you have to apply the appropriate mark-up for each type of cost, so the mark-up will vary depending upon the types of costs you are looking at.

Q. In relation to the MSC, that might well be an example of a non-fuel passenger cost, would you agree? It is not a fuel cost.

A. Yes.

Q. It is probably not a flight -- non-fuel flight costs is the second category, and then non-fuel passenger costs. So it is probably going to be in the third category?
A. Yes.
Q. So something on the face of that analysis which looks like it has a lower elasticity than the other two?
A. Yes. But as I say, that does not really tell you anything without knowing what the appropriate mark-ups are.
Q. Well, when you come over the page, you did cite -- you only cited the one in relation to fuel costs. Why did you not mention elasticity in relation to the category much more directly applicable, which is potentially non-fuel passenger costs?
A. Well, I suppose the point is they are all here on the table, are they not?
Q. But you are summarising the ones you consider to be particularly important. So you are only citing the highest one or the one that looks significantly lower for the relevant type of costs?
A. Well, as I say, there are all there in the table.
Q. You also suggest it is less helpful, the Gayle and Lin study. That is in Table 60 on page 232 {RC-F/10/232}. That is concerned, again, with crude oil prices and changes in airfare, but that concerns a cost decrease.

I would suggest that is exactly what is relevant here. In the counterfactual there will be lower MSCs. So what you are looking at is whether prices would have been different in the counterfactual. So that is obviously a relevant study to look at as well, is it not?

A. Well, I would view it the other way round, that the counterfactual is a situation where the MIF did not exist, so the MIF had never been introduced. So what we are looking at is the impact of the cost increase caused by the introduction of the MIF.

Q. Well, it is not a case of the -- maybe we are arguing about law here, but I will put the question to you once and then move on. It is not a question of the MSC -- or MIF never existing. Mr Merricks' claim period is specific to 1992 to 2008, not changing history about what happened before that.

A. Well, the way I have always thought about it is that the counterfactual is the situation in which -- so generally in these cases, the counterfactual is a situation in which the overcharge had not -- had never been in existence, had never been introduced. That is normally the way I think of the counterfactual. So therefore, when one is doing this type of analysis, what you are analysing is the impact of the factual increase in

prices.
Q. But we know what the factual was, so we are looking at the counterfactual where it was not. So it is a lower cost?
A. Yes, but we are not looking at a situation where what happens, you know, at the end of the period when the overcharge is removed, the question that we are asking is: well, suppose the overcharge had never been there in the first place, that is the way I think of the question.
Q. Let us turn then to the analysis that you have actually -- the analysis you have conducted by reference to public data. You do some analysis in relation to travel agents, you identify a Consumer Price Index for package holidays, and then you compare that to a composite index consisting of an SPPI, which is Services Producer Price Index, for air transport, and then a labour measure based on the Average Weekly Earnings for administrative and support services.
A. Yes.
Q. In relation to the SPPI, that tracks price changes for air transport services provided by UK businesses to other UK businesses and the government, does it not?
A. Yes.
Q. So that will include air tickets sold to, you know,

businesses for their own use, so business travel?
A. Yes.
Q. You would expect business air travel to have a rather different profile of cost from air travel sold as part of a package holiday?
A. Possibly. We do not know.
Q. I suggest to you it is quite a poor -- it is likely to be quite a poor measure of the cost of air tickets purchased by travel agents for sale as part of package holidays if you are including a lot of very expensive business travel in that measure?
A. Well, the point is that that is what travel agents might be purchasing, you know. So travel agents are purchasing these tickets to then sell on to other people. So that is exactly what this SPPI is measuring, it is measuring the price of the air tickets which are sold by the airlines to an intermediary, and the intermediary is a travel agent.
Q. Yes, but your CPI is only in relation to package holidays. So it may be that businesses do sometimes buy business tickets through a travel agent, but you are only analysing the package holiday bit of it, are you not?
A. Yes. The reason for that is that happens to be the only CPI that is available for this sector. There is no

other CPI that I could identify for the travel agent sector.
Q. I come back to my question: it is a poor measure of the cost of air tickets purchased by travel agents for the sale of package holidays, something that includes a lot of expensive business travel?
A. Well, I suppose the way that I was looking at it is that the CPI I am using is trying to capture the prices of what is sold by travel agents, rather than just simply some, you know, narrow subset.
Q. But it is not, because the CPI is about package holidays, it is not about people buying business tickets. It is package holidays?
A. Yes, but package holidays -- so package holidays are sold in competition with people purchasing the air ticket and the accommodation separately. So you would expect there to be a relationship between the CPI for package holidays and, you know, the individual components when they are sold by travel agents.
But I suppose your point -- I am trying -- I can understand your point, Mr Cook, which is what you are saying is that this is capturing -- the CPI I am using is sort of capturing something which is sold to consumers and not to businesses, and you are saying that the SPPI is capturing both what is sold to consumers and

what is sold to businesses, and to that extent there is a bit of a mismatch. So, yes, I can see that point.
Q. Thank you.
Air travel is also only part of a package holiday. You are not using any data on what would cover the accommodation or food services which are likely part of a package holiday that you would buy. That is fair as well, is it not?
A. Yes, that is fair. I mean, the reason that I focus on the air fare is that the evidence shows that that is the majority of the sort of input costs into travel agents.
Also, in terms of the other component, so the accommodation services, I mean, a big part of that will be a labour cost anyway.
Q. Sorry, a big part of accommodation will be labour cost?
A. Yes.
Q. That will probably be labour costs abroad, will it not?
A. It will be a mixture.
Q. But it will be abroad?
A. Well, some of it will be abroad and some of it will be in the UK.
Q. I think we can know that the vast majority of package holidays sold are to go abroad; particularly if you are flying, that is always going to be going somewhere fairly far away, is it not? You might go to Scotland,

but in general this is going to be foreign holidays?
A. Well, I do not know.
Q. Now, in relation to the AWE measure you use, this for the administrative and support services activities, and that is a much wider category of activities than administrative staff working for a travel agency, is it not? Ms Webster says it includes things like window cleaning and private security, so it is a much wider measure and not applicable to the cost of people working in travel agencies?
A. Well, again, as with the previous case, it is the narrowest index that is relevant to the travel agent sector.
Q. Again, it is just measuring average weekly pay. It is saying nothing about the number and category of workers actually employed by travel agents over time?
A. Yes, although I am not really quite sure what the significance of that is.
Q. Well, let us say you are a travel agent and you start off at the beginning of the Merricks claim period and you have a shop on the high street which people come in, and you show them brochures and, you know, you spend -- each person spends time with an agent buying a holiday, and you then move to selling over the internet, because obviously that is how most people buy their holidays

now. The number of staff you are going to employ to do that is likely to be a lot smaller, because effectively you have taken a large part of the human element out of that process, have you not? So what I am putting to you is that looking at average weekly pay is going to be a very poor measure of the cost actually incurred by travel agents?

A. Well, we have the numbers on this. So if we go to Table 63, which is on page 236 {RC-F/10/236}, so that shows the wage component here. So it varies between 22% at the beginning of the period and 29% at the end of the period, with an average of 22.7%.

Q. Yes. But your AWE measure is not showing that at all, is it?

A. Well, I use -- so in my combined index -- so I use this weighting of 22.7%, which is the average over the period.

Q. Yes. But the problem with that is, without knowing how many staff that equates to, you do not know -- you can look at the headline number and say, you know, it is a similar percentage, but that might reflect the fact you are now employing a lot more IT staff who are much more expensive than somebody who is just engaged in selling holidays, so you do not have any way of evaluating those kind of changes in staffing, do you?

A. No. All you know is the overall labour costs, yes, that is correct.
Q. Now, you then estimate your pass-on elasticity, and we see that is at paragraph 4.304. Now, this analysis does not pass the bounds test at 5%, does it?
A. No, it passes at 10%.
Q. 5% is the standard level used to determine whether a statistical result is significant or not, is it not?
A. Well, people sometimes -- they often -- normally, people will test at 1%, 5% and 10%, is normally what people do in the academic literature.
Q. So basically you have a much lower level of confidence in whether this is showing a real correlation between -- or real relationship between costs and prices here?
A. No, I would say there is a slightly lower level of confidence.
Q. Then you calculate your pass-on elasticity, and you convert that to an absolute pass-on rate by making two adjustments. We have seen, first, reflecting the average margin, which you do using SUT data. I have already asked you about that. You said that is not reliable, but we have been round that set of houses already. Then you apply the same average affected VAT rate, the economy-wide one.

You will presumably be aware that most forms of travel, and that includes air travel, are zero-rated for VAT, and that applies to the travel component of a package holiday, so, again, you are applying an economy-wide rate to a sector which is largely zero-rated?

A. Well, I think we discussed this before. As I say, this is -- this then averages out when you average across the different sectors.

Q. But, again, as we will see, it is actually only a subset of sectors where you actually apply this economy average, is it not?

A. Well, I apply it in all of the cases where I use public data.

Q. Now, in paragraph 4.308 you then consider -- 4.309, you then consider sector extrapolation, so that is whether you can use your pass-on estimate which you calculate in relation to travel agents, coming from your composite index, and whether that is something that you can then apply. But pausing for a moment, I mean, this is essentially the travel agent figure. I mean, that is based on partial measure of COGS plus a labour element. So it is still only a part of the costs that are being -- again, it is not a total cost test at all, is it?

A. No.

Q. If we look -- go back to Table 63, which is at page 236 {RC-F/10/236}, we have the domestic inputs. You have actually only looked at the air travel aspect of that. I think your data shows that is about 75% of domestic inputs, is the air travel bit, and then wages, and then you have other costs which is 23.8%. So actually you have only looked at about 70% of the costs incurred by travel agents?
A. Well, you say "only 70%". I would say it is 70%. You know, it is the vast majority.
Q. But you have looked at the much more COGS end of the process, have you not?
A. Yes.
Q. So sector extrapolation, which is 4.309 here. So you have your number for travel agents, and you then apply that to the rest of the travel sector, including -- I think the two particular ones you focus on in paragraph 4.310 are the two next biggest, largest, which are airlines and railways.
As a starting point, both of those two are zero-rated for VAT, so again I suggest you are basically applying an inflated economy-wide rate here. That is right, is it not?
A. No. As I have said, that just comes out in the wash when you average across the sectors.

Q. Now, in relation to airlines, you say at 4.310(b), that it is appropriate to use your travel agent pass-on rate, because previous studies have indicated absolute pass-on rate for airlines are high and close to 100%. I suggest this is where the fact you do not dwell on the Wang study is quite important, because, as we saw, there were the different price elasticities for the different elements, including a much lower one for non-fuel passenger costs. So that immediately begs the question, when you are looking at MSCs, about whether the numbers you have produced are relevant at all?

A. Well, I think this is a general point that does not just apply here but across all sectors, which is that I do not try to extrapolate from these elasticities in the literature. So where the literature provides a pass-on rate, then I use that as a cross-check on my results. Where the literature produces an elasticity, you cannot really interpret the elasticity unless you know the appropriate mark-up, and the point is we do not know what mark-up to apply to these elasticities.

So consistently across sectors, I do not rely on studies which just simply produce elasticities, I only look at the studies which actually produce a pass-on rate.

Q. But that study certainly raises the possibility that when you are looking at other costs for travel agents, and certainly other costs for sectors like airlines, there may be a completely different pass-on rate for them compared to the COGS measures?

A. It tells us nothing. Without knowing the mark-up, it tells us nothing.

Q. You simply have not tried to do a mark-up on that?

A. Well, the exercise of trying to do that for every study I have looked at, which would be -- I think in total I have looked at about 200 studies; about half of them only estimate an elasticity, so that would be about 100 studies where I would have to go out and do research in order to try and find the appropriate mark-up. I think that would be a disproportionate exercise, given that I am only using these studies as a cross-check.

Q. Well, I suggest this is one is particularly relevant because it seems to show, on the face of it, different elasticities for different kinds of costs, and quite significantly different elasticities.

A. Well, it presents the problem that I have just explained, that without actually knowing the appropriate mark-up, which is probably impossible to actually calculate, it is impossible to know how to interpret these results.

Q. Now, in relation to railways, which you deal with in the middle of subparagraph (b) there, you say:

"One study also shows high pass-on rates in other transport subsectors, for example 117% for rail transport."

That was the EU-wide study that we looked at a moment ago, so that is a general EU-wide analysis of pass-on for railways.

You presumably are aware that there has been extensive price regulation in the United Kingdom in relation to the price of rail tickets?

A. Yes. Some ticket prices are regulated and some are not, is my understanding.

Q. Where price regulation has taken place, it has normally been based on some kind of RPI escalator. Are you aware of that?

A. Yes.

Q. Rather than a detailed analysis of costs, it is an RPI plus X model year-on-year.

A. Well, that RPI plus X model is created also bearing in mind the costs of the firms. That is how utility regulation works. The utility regulator has to take into account the costs of the firms, otherwise the firms do not stay in business.

Q. Now, you just simply have not given any thought as to how that regulation actually impacts on pass-on for railways, have you?

A. No -- well, I have not tried to calculate a pass-on rate for railways here.

Q. But you have read across or extrapolated your travel agent number to a sector which is regulated, without considering whether that regulation has an impact. That is right, is it not?

A. No. So I have not looked in detail at the railway sector, no.

Q. If we go to paragraph 3.262 in your report, which is on page 134 {RC-F/10/134}. This is, going back to the previous page, we see at page 133 that this is the section headed "Price Regulation" {RC-F/10/133}, so we are dealing with that.

If we go to 3.262 {RC-F/10/134}, you have considered how different regulation may operate differently. You say:

"In any case, I do not use evidence on price setting mechanisms in regulated industries to estimate pass-on rates. This is because the way in which costs are treated in regulatory pricing decisions in those industries will be implicitly reflected in the pass-on rate I estimate from price and cost data."

So that is your answer to regulation, that it will be implicitly reflected in the pass-on rates you calculate.

Mr Coombs, you do not actually calculate any pass-on rate for a regulated industry, do you?

A. No. Well, certainly for railways I do not calculate a pass-on rate, no.

Q. For any regulated industry?

A. No, I do not think I do, no.

Q. No. So when you say regulation will be implicitly reflected in the pass-on rates you estimate, that is just simply not right; you do not do that at all?

A. Well, if I had calculated a pass-on rate for a regulated industry, then that is what would have happened. So that was the approach. But in practice, I think you are right, that I do not think any of the sectors -- well, maybe to -- no, I cannot think of any of them where it we will actually -- the price will have been price regulated.

Q. So that is not a justification for trying to read across from an unregulated sector, a different unregulated sector, into a regulated sector; in the pass-on rates you simply cannot read that across, given the regulatory overlay that takes place?

A. Well, I am not trying to -- I am not saying that I have calculated a pass-on rate for the railway sector. All I am saying is I am saying, well, I have some evidence from previous studies, which suggests that the pass-on rate for railways is likely to be high, and probably higher than the estimates that I have calculated for the travel agent sector. That is the only point I am making here.

Q. But then you simply apply the travel agent number?

A. Well, because I do not have any other evidence. I think the point -- if you go to 4.311, I just simply say that my pass-on estimate for the travel agent sub-sector is my best available evidence on the pass-on rate for the travel sector, the point being that, well, certainly at this stage, I did not have any other evidence that -- the only evidence I had is my estimate for the travel agent sector.

Now, when it comes to Coombs 14, I then had the benefit of looking at the work that other experts had done. So I looked at the estimates for Travix. So Ms Webster, Mastercard's expert, did not produce an estimate for Travix. Mr Holt did. His estimate was, I think, about 100%, 102% --

Q. None of this is relevant to railways, is it?

A. Well, it is relevant in the sense that it is a cross-check so I use that as a cross-check. The point is that it is the only evidence I have that I can rely on, so, you know, the question you are raising is that, you know, why am I using this evidence for railways? My point is, well, what other evidence am I going to use? This is the only evidence that I have.

Q. What I am putting to you is that you are suggesting it is appropriate to read across in circumstances where the regulatory overlay means you just simply cannot make any assumptions. You say it is the best available evidence; I am suggesting to you it really is not relevant evidence at all.

A. Well, I do not agree with that. So I have taken the fact that I have an estimate for the travel agent sector, I have compared it with the evidence from previous studies for railways, and on that basis my estimate for the travel agent sector, if anything, looks conservative.

Q. With railways, you are looking at an EU-wide study where there is likely to be very different -- many of the railways in Europe are government owned, government funded, they are just simply going to have nothing like the same regulatory framework that we do. Again, it is not a number you can see as in any way meaningful?

A. Well, the point is it is the best evidence that I have.

Q. If we turn then to temporal extrapolation, at paragraph 4.312 here. You do a similar analysis. Here, you only exclude the last three years of data, so that is 2017

to 2019, and say that does not substantially affect your results. I mean, at this point, if you are looking at a data series, and I think this is 2000 to 2016, essentially, you end up looking at. I mean, that is a data period which is -- you know, a large part of that is the non-Merricks period?
A. Yes.
Q. So it is not really providing you with very much guidance at all as to whether your number from 2000 to 2019 can be read across to the Merricks claim period?
A. Well, the particular issue that I have with this sector is that the data is available only quarterly, rather than monthly, so it means that I have fewer observations to start with. So, therefore, it is even more difficult to remove observations from the sample.
Q. If we go again to Ms Webster's reply report, Figure 5 {RC-G/13/74}. We are in "Travel Agents". Again, we see, if we look at the Merricks claim period, the light blue, when she applies your data on your analysis, you end up with a number which is now -- it has gone from being 87.5%, which was your number, to below 50%.
A. Well, this is -- I think she ends up using something like 40 data points or something, which is, you know, really far too small a sample for this type of model to produce a result that you will want to rely on.

Q. Well, it ends up giving us some information that indicates that your estimate essentially is too high for this kind of time period?
A. Well, I would disagree with that, for the reasons I just said.
Q. If we move on to the next sector, which is "Household". If we look at Table 51, which is on page 218 {RC-F/10/218}, you see this is a sector which includes a number of rather different industries. The most significant for present purposes is number 1, which is furniture stores, because the analysis you do is just in relation to furniture stores, is it not?
A. Yes.
Q. But then a number of quite -- household appliances, electronic stores at 19.7%, and DIY stores at 35.8%.
In terms of previous studies, if we look at the ones that you cited there, which are at paragraph 4.222, which is at Table 50, your summary at the start of this section indicates that previous studies have estimated pass-on rates to the household sector ranging from 38% to 82%.
If we look at the studies, actually the numbers are rather lower than that, are they not? Table 50, Baxter and Landry, and that is the only study which actually includes the UK. So the only UK data we have shows

pass-on rates of 14% to 31%.

A. Yes.

Q. So the UK data was much lower than the range you are quoting. Now, you suggest this -- or downplay the relevance of that at paragraph 4.223(b), where you say it may be due to the fact import costs constitute a small proportion of total costs. That may be the reason why there is quite a low level of pass-on.

Firstly, obviously it is not correct to say in the context of the UK that import costs will be a relatively small percentage of total costs. I mean, a large proportion of our furniture industry is imported furniture, is it not?

A. I do not think that is right. Let me just find the --

Q. It is table 55. About a third of the market, the data shows. 222 {RC-F/10/222}.

A. Yes, so domestic inputs are far more substantial than imports.

Q. Imports are about a third of ... So domestic inputs 53%, imports 26%, means ...

A. Yes, domestic inputs are twice as important as imports.

Q. So I am looking here at sort of the relevance of the study, which was potentially saying that because imports were a small percentage, that might be the reason for the low pass-on rate, saying certainly in the UK imports

are quite a substantial part of the furniture business, it is one-third?
A. But that is not the relevant point here. The relevant point here is about the study itself and the proportion of imports in the data that the study was looking at.
THE CHAIRMAN: Are we back in paragraph 4.223?
MR COOK: Yes, we are.
THE CHAIRMAN: Page 217 for the operator {RC-F/10/217}.
MR COOK: You are saying that is in relation to the study.
What this alternative then indicates is that because it is only a small sum, the pass-on rate is correspondingly lower. Again, that would be a relevant point in the context of the MSC, would it not?
A. Sorry, can you repeat, please?
Q. If the small cost is passed on to a more limited extent, that would again be a relevant point to note in this context, would it not?
A. No, I think the point is that it is more difficult to identify the pass-on rate of a small cost, which is, for example, why nobody is trying to estimate the pass-on rate of the MSC. We are trying to estimate the pass-on rate of a proxy for the MSC.
Q. They are not saying it is difficult to do it, they are simply saying pass-on rates are relatively low. Not saying: we tried it and could not get answers. So they

got answers, but they are much lower because it is a small cost?
A. Yes, but that is related to the fact that it becomes more difficult to estimate the pass-on rate when it is a small cost.
Q. You also refer to, and I think you focused upon, the Pimentel et al numbers. That is the second one in table 50, page 216 {RC-F/10/216}. So that is some analysis that was done in relation to Brazil in relation to the period 1996 to 2014, and that is where you get the 82% number which you cited in the summary of your findings at paragraph 4.217(a).
If we look at that study, which is at {RC-J1.6/115/1}. Firstly, in relation to Brazil, it is likely to have quite a different retail environment and economic conditions from the UK, would you agree?
A. I would agree, yes.
Q. If we then go to table 4, rather than 14, table 4, at page 11, which is where you get the numbers from {RC-J1.6/115/11}. If we go down, we can see where you get the 82% number from. That is for, it is number 17 activity, electronic material and communication equipment. That is not a number that is relevant to furniture and furnishings, is it?
A. No, but at this point I am not focusing on furniture and

furnishings, I am focusing on previous studies for the household sector.
Q. Well, electronic material and communication equipment is often going to be -- a lot of that is going to be business orientated, is it not?
A. Well, I do not know.
Q. If we look at furniture and furnishings, this shows the 38% figure, but this report distinguishes between positive cost shocks, i.e., where there is an increase in costs, and that has a 38% pass-on rate, and then an 11% figure where costs fall. Do you see that?
A. Yes.
Q. So it is another study that shows there is a potential difference, depending on whether you are looking at costs going up or costs going down?
A. Yes.
Q. I have already asked you about the relevance of that, but I suggest that it is relevant to note there is that distinction which exists, is it not?
A. Yes. Well, as I said, I focused on looking at price increases rather than price decreases.
Q. So turning now to the public data you analysed. You carry out a single piece of analysis here. You compare the CPI for furniture and furnishings to the PPI for furniture produced in the UK?

A. Yes.
Q. So as the name suggests, there is already an automatic disconnect between the two measures, is there not, because the CPI index includes furnishings while the PPI index is just for furniture?
A. Well, if you actually sort of look at the match between the indices, so --
Q. It is 4.228.
A. If you go to Table 52, which starts on page 218 {RC-F/10/218}, this shows the correspondence between all of the available potential indices for the household sector, and what I did was I looked through to try and find where was the best match. So on the second page here, 219, towards the bottom, you see furniture, where the match is 99% in one direction and 71% in the other {RC-F/10/219}. So of all the available choices here, I chose the one where the match was closest.
Q. So 71%, that means the PPI components account for only 71% of components in the CPI?
A. Yes.
Q. So there is an immediate 30% disconnect to the two data series?
A. In one direction, and an almost perfect match in the other direction.
Q. Then -- but of course the disconnect is greater than

that, because the PPI basket relates to UK production, so, again, that is going to reflect different weightings of the products, is it not, based on whether products are predominantly imported or predominantly produced in the UK?

A. So, yes, I mean that is a sort of different way of looking at things. So if you look at it that way, yes, domestic inputs are a little bit over 50%.

Q. Well, no, it is not a different way of looking at it, it is an additional point. Because the 30% disconnect I put to you is because there are a lot of products, like carpets, for example, which are present in the PPI but are not present in the -- sorry, the other way round, that are present in the CPI but are not present in the PPI. So that is the category of products, that is just only in one sector.

A. Yes.

Q. When we come to imports, the point I was making to you there is we are looking at the 71% where they are the same products, but noting the fact that the weighting of products within that 71% is likely to be very different because the PPI measure is about UK production. So if UK production of chairs is very low, it will have a small percentage in the PPI but there will be a large percentage in the CPI?

A. I think the point here is simply that what I am capturing is I am capturing the cost of domestic inputs, which is just over half of the cost here.
Q. But what I am pointing out to you is there is this weighting disconnect between the two measures, because the scale of a product will reflect either production or consumption in the two?
A. Yes. Sorry, I am getting a bit confused here. But I think the point we can agree on is that there is a less than perfect match between the PPI and the CPI, and we can also agree that what I am measuring is domestic inputs, which is just over 50% of the cost.
I think there is a question then about whether you actually think that the imported inputs, whether the prices of those are going to move in a different way from domestic inputs, because presumably these are substitutes that retailers and consumers can choose whether to purchase the imported or the domestically produced product, and therefore it may well be that there is some connection between the prices of the two.
Q. If they are substitutable products, it might be the case. With food and drink, sometimes they are just products which are essentially ones we do not produce here any more?
A. Yes.

Q. Or produce in very small numbers where there is not going to be a substitution effect?
A. Yes.
Q. So ultimately this just a measure of COGS, is it not?
A. Yes.
Q. Now, in terms of the analysis you do here in terms of modelling choices, you state at paragraph 4.250, which is on page 225 {RC-F/10/225}, I wanted to ask you about subparagraph (d) here. You say:
"I also include a set of monthly dummy variables in the model to account for the clear seasonality in the furniture CPI."
Which you have explained, in paragraph 4.246 on the previous page, is prices are usually lower in January and July corresponding to sale seasons.
Then if we look at footnote 709, you have actually included dummy variables in relation to eight months of the year. You have January and July, but also another six months. What led you to include those as well?
A. Well, I tested these dummy variables to see whether they were significant, and identified that they were significant in I think it is eight months of the year. You know, different -- these are different dummy variables for each month, so there is a different effect in each of these different months.

Q. But it is understandable you need to take account of sale season in January and July, but in relation to all the other months of the year, why are you including a dummy variable to take account of what is just likely to be an inherent part of the pass-on process?
A. Well, you are saying that sales only happen in January and July and that for the rest of the year prices are exactly the same. Well, I have no reason to believe that that is the case. Instead, I have tested using the data to see if there is a significant difference between prices in different months, and what I find is that there is a significant difference between the months I identify here, so I include dummy variables for those months.
PROFESSOR WATERSON: Do these dummy variables follow a sort of pattern or do they jump around all over the place?
A. To be honest, I cannot remember.
PROFESSOR WATERSON: Okay.
MR COOK: Now, having identified your eight months of dummy variables, you then apply the test, and we see that set out at 4.251. So you pass the bounds test at 5%. You pass a test for serial correlation. You do not, however, pass a test for heteroskedasticity, do you?
A. No.
Q. As you say in paragraph 3.171 of your first report, the

bounds test relies upon there being no serial correlation but also no heteroskedasticity?

A. Yes.

Q. So when you have heteroskedasticity, that means the bound test result is simply no longer reliable?

A. Well, it means -- it does not mean to say you cannot rely on it. It means that there is an uncertainty around the result from the bounds test because of the presence of heteroskedasticity.

Q. Well, you say you cannot rely -- you say you can rely upon it, but what you are saying is the results of the bound test is uncertain whether it actually shows anything genuine or whether it identifies a false relationship.

A. It introduces some uncertainty, yes.

Q. Why are you putting forward analysis which basically says you cannot say, with confidence, that there was a true relationship?

A. Well, what I am saying is I am saying there is some statistical evidence in a relationship, is what I am saying here, and I am explaining that these are the results I get.

Q. Now, you seek to explain the fact you do not meet the heteroskedasticity test in paragraph 4.252(d), and you say that might be -- if we go over the page to page 226

{RC-F/10/226}, you say a likely reason is the model fails because the clear seasonality is not fully compensated for in the monthly dummy variables. I mean, that may or may not be right, but the end result is you simply do not have that reliability or the support for saying that your bounds test result is meaningful?
A. So, yes, I agree that it creates some uncertainty regarding the results of the bounds test, yes.
Q. Your results here are very susceptible to exactly what modelling choices you make, are they not? If we go to Ms Webster's reply report {RC-G/13/55}, A17(b), she explains that this is extremely sensitive to the parameters chosen for the maximum number of lags. So in the household sector, which is what we are looking at, increasing the maximum number of lags from two to three leads to the bounds test not passing the 5% level. Then four lags, it does pass. Six lags, it does not pass. I mean, all of this is indicative of a highly unstable bit of analysis, is it not?
A. Well, I think it relates back to the point we have just been discussing, which is the problem of trying to accurately control for seasonality in this data.
Q. But the end result is you end up with analysis that is just simply not reliable?
A. Well, I would not say it is not reliable. I would just

say that it is more difficult to produce a robust estimate when you have seasonality.

Q. Well, you simply are not in a position to tell the Tribunal whether that is a robust number at all?

A. Well, I am saying it is my best estimate of the pass-on for this sector.

Q. Now, having applied your margin test adjustment, your VAT adjustment, and this is a sector where VAT is payable, you get a result, we see at paragraph 4.256, which is 110.9% for the furniture sector.

Now, if we go back to your -- footnote 30 of your first report on page 26 {RC-F/10/26}. If you can possibly make it a little bit bigger at the bottom of the page. This footnote is dealing with the specific circumstances in which you can get pass-on above 100% as a matter of economic theory. Those conditions you identify are: imperfect competition, imperfectly competitive markets, so including monopoly and oligopoly, and where the demand curve is highly complex.

If we go -- and you would agree those are the conditions for economic theory pass-on above 100%?

A. Well, I think the context here is that I have an estimate which is only slightly above 100%, so these factors really become relevant when you are expecting a pass-on rate significantly above 100%.

Q. Well, given the level of uncertainty that we have seen in relation to the numbers, do you -- are you suggesting to the Tribunal you think it is above 100% -- the actual pass-on rate is above 100% or not?
A. Well, I am saying my best estimate is that it is slightly above 100%, 110%.
Q. So I am showing you what you have said is the economic theory which would lead to results above 100%. If we go back to paragraph 2.4(b), which is at the top of page 26, then you explain that essentially neither of those conditions are met, you think:
"... in competitive markets (such as those that Constitute the UK's retail industry), supply curves are likely flat ... Any effects related to the price elasticity of demand ... tend to be diluted in the presence of a large number of suppliers ..."
So you have no reason to think the demand curve for furniture is highly complex?
A. No.
Q. So no reason to think there is any -- that there would in fact be pass-on above 100% in this sector?
A. Well, no reason to expect a pass-on rate that is significantly above 100%. I think the -- I think maybe what we are debating here is, you know, how close to 100% the pass-on rate might be.

Q. I am asking you about whether you think -- whether you are in a position to say to the Tribunal it is above 100%?

A. Well, I think the pass-on rate could be slightly above 100%, yes, but I would not expect it to be materially above 100%.

MR COOK: Sir, I think that is probably a convenient moment. I am coming on to a different section.

THE CHAIRMAN: Yes. A ten-minute break.

(3.10 pm)

(Short Break)

(3.20 pm)

MR COOK: Mr Coombs, the next step in your analysis, which is at paragraph 4.256, is your sectorial extrapolation. That is at page 226 {RC-F/10/226}.

So at this stage, you have a number simply for the furniture sub-sector which, as we saw, was 22% -- 21.1% of the sector, and then you read that across to the rest of the -- the other 79% of the household sector. It is fair, I think, to summarise, the reason for that is you say there is some overlap between competitors in different subsectors. Is that the core of your analysis?

A. Yes.

Q. But the fact that a business sells different products

does not mean that all those products will have exactly the same level of pass-on, does it?
A. No. It might be the case that there are differences, but I think the point is these firms are likely to have very similar business models if they are selling very similar products, and therefore you would expect there to be a similar level of pass-on.
Q. Well, we saw, for example, in relation to alcohol in the food and drink sector, that seemed to be something that had a particularly high rate of pass-on. So even a context like that, you know, even where you have a firm selling different -- you know, a range of products, they may have pass-on rates that are different between different categories of products?
A. Yes. So what you are suggesting here is that there will be a difference in the pass-on rate between, say, furniture and consumer electronics.
Q. Yes.
A. I suppose the question I would ask is: well, if consumer electronics and furniture are being sold in the same retail premises by a business which is selling them both, effectively using the same business model, then you might expect the pass-on rates to be very similar.
Q. Consumer electronics is an interesting example, because, you know, there are a lot of consumer electronic

specialists, sort of the Curry's, the Dixons, I know many of them are owned by the same people, but you have a lot of specialist businesses, and your argument then is to say, well, John Lewis also sells some consumer electronics, so that must indicate it has a similar pass-on rate?

A. Well, it is not just John Lewis. I am saying there are a number of retailers that sell both of these products, and therefore you might -- you find some overlap between them.

Q. If operating in different competitive conditions, then there is no reason to think that the pass-on rate will be the same for consumer electronics, where it is battling against a whole bunch of different retailers from the ones it battles against in relation to furniture?

A. I suppose the point I am making is that you would expect there to be actually very similar competitive conditions if it is the same retailers selling these products.

I mean, I think the other point that is relevant and that we are sort of avoiding here is, well, you know, what is the alternative? So what alternative evidence do we have about the pass-on rate for these other sectors? So in the household sector, we do not actually have any merchant data, we do not have a merchant in this sector, so we are left with looking at the public data, and if we consider the three largest sectors here -- so this is Table 51 on page 218 {RC-F/10/218}, which I think Mr Cook has already taken us to previously -- you see that the three largest sectors are furniture, electronics stores and DIY stores.

So I have produced an estimate for furniture stores. DIY stores, which is the larger sector, as far as I can see, there is no data available that would allow one to estimate the pass-on rate for DIY stores. Electrical stores, the problem there we have is inputs -- imports. So Mr Cook has pointed out that something like, whatever it was, 20% of furniture products are imported. In the case of consumer electronics, the proportion is much higher. Hardly anything is produced in the UK, it is virtually all imports, and there is no data for the price of imports that could be used to estimate a pass-on rate for electronic stores.

So the issue here is, well, do we just give up and say, well, it is impossible to estimate a pass-on rate for these other subsectors? Or do we say, well, what is the most suitable information that is available? What I am saying is I am saying, well, given the similarity and overlap between retailers of these different products, the best evidence I have is my estimate for the furniture sector. So it might not be perfect, but it is the best estimate that I have.

Q. What I am testing is how relevant it is and whether you are just simply applying a number which has no connection to it at all.

So let us look at, then, DIY being the largest group. The overlap with DIY stores, I mean, DIY stores occasionally sell a little bit of furniture in one corner. That is radically different from suggesting that that is likely to infect their pass-on rate for lumber, for tiles, for all those kind of building materials?

A. Well, so they do sell furniture, and we do not have any evidence on the pass-on rate for anything else that they sell. So the best evidence we have for the pass-on rate for DIY stores is the estimate for furniture, because there is no other estimate to rely on.

Q. In relation to temporal extrapolation, again, it is the point I put to you before; you are only looking at excluding 2015 to 2019, so you still have data, which is predominantly Merricks', and then you look at margins by reference to the same flawed sub-data. So, again, I suggest to you that nothing about that is telling you how relevant your numbers are to the Merricks claim period.

A. Well, we have already discussed this point and I disagree.

Q. If you had anything additional add, that will be the moment, but otherwise if we are going over territory again, we do not need to repeat answers.

The next sector then is entertainment. If we can turn to Table 32 of your report, which is page 166 {RC-F/10/166}. Table 32 shows a breakdown of the different kinds of businesses that come under the entertainment categorisation: restaurants, which are important for these purposes because those are what you do some analysis for, are the largest at 46.5. Then we have -- the big ones are gambling, 15.7; cinema, theatre and dance, 12.7; then sports and games establishment at 10%; then a host of smaller sectors here.

In terms of previous studies when you look at these, at page 163 {RC-F/10/163}, you summarise the effect of the studies as being -- if you look at 4.75(a) -- pass-on rates:

"... close to or higher than 100% for ... taxes to on-trade alcoholic beverages and football ticket prices and 70% for ... minimum wages to restaurant prices ..."

If we look at Table 30 then, the PwC study, which does, as you say, have 100% for on-trade, but it is 70% for the off-trade channel. So, again, you have sort of focused on the higher number, but not the lower number. Why?

A. Because that is the number that is relevant here. We are talking about the restaurants sector, we are not talking about off-licences, so it is the number that is relevant to this sector.

Q. Then if you look down to Professor Szymanski's analysis, which is now going back 50 years, so even longer than the Merricks claim period, his absolute pass-on rate is 107% for nominal but it is only 13% if it is adjusted for inflation. So, again, I suggest to you that is an indication that you cannot really rely on the 107%. The 13% reflects what was going on at that time with inflation.

A. So in his report, Mr Holt identifies some reasons why he decides not to rely on this study. I cannot remember exactly what they were, but when I looked at them I thought he had some valid points. So actually in what you call my second report, Coombs 14, I actually say that I no longer rely on this study.

Q. Okay. Then if we go to Table 31 {RC-F/10/164}, we get Benzarti, which shows pass-on rates in relation to a cost decrease of 13.6%, which, again, I suggest to you, is relevant in this context. You can disagree about whether cost reduction is irrelevant or not, but

I am pointing out to you it indicates there is a range of outcomes depending on the nature of the cost and the cost increase.

A. Well, I would disagree. As you mentioned this morning, Mr Cook, there is the phenomenon of rockets and feathers which might be relevant here.

Q. Now, turning to the analysis you do carry out. You look just at restaurants, and you do that by comparing a CPI for restaurants and cafés, the Consumer Price Index for restaurant and cafés, to a composite index, which is the PPI for food, beverage and tobacco, and then the average weekly earnings data for accommodation and food services activities.

I am just going to look at how comparable those data series are. In terms of the PPI that you use, that is the same one you used for food and drink, is it not?

A. Yes.

Q. So it has the similar issues that I have already put to you. It includes animal food prices. It will not include a lot of food and drink items that are actually purchased and sold by restaurants, because they are exclusively imported, so they are not produced in the UK, like the 94% of fruit and vegetable we saw in the data earlier?

A. Yes. I mean, if we go to Table 34 {RC-F/10/169}, we see

that actually --
Q. I was going to ask you about Table 34, because Table 34 seems a sort of rather surprising bit of analysis on the basis that, given what we have seen about the percentage of food and drink imported into the UK which is -- in the food and drink sector which is important to the UK, there must be a problem with this data to suggest that restaurants do not sell any imported, or do not sell any materially imported food and drink?
A. Well, I think maybe the point is that restaurants do not directly source supplies from overseas, they directly source supplies from within the UK, and so that is what is reflected in the table.
Q. Just explain what you mean by that. So if they buy it from a wholesaler, are you saying that that is treated as domestic even though it is a French bottle of wine?
A. Yes.
Q. Okay. So these percentages actually then mask the fact that the domestic inputs will be often -- will often therefore be actually imported goods, they just come through some stage in the supply chain?
A. That may be the case, yes.
Q. Well, we can use some common sense. We all know that if you have a wine list in a restaurant, the vast majority of bottles of wine on there are imported. So we know

that restaurants do import a certain amount. We know that a lot of goods -- a lot of vegetables, fruits, only come into the country by imports. Again, you buy those in restaurants. So there must be quite a lot of imported food and drink in restaurants?
A. Yes. I suppose the point is -- the issue is the point in the supply chain at which they are purchasing it. So if they are purchasing it from a domestic wholesaler, then that should be picked up by the PPI for domestic products.
Q. So the PPI will be doing UK production?
A. Yes.
Q. So it would not be picked up by the PPI.
A. So you are saying that the PPI is not going to -- that if a French bottle of wine is imported and then resold by a wholesaler, that is not going to be picked up by the PPI?
Q. Yes.
A. I am not sure about that, to be honest.
Q. Well, that seemed to be what you said in relation to the PPI index for food, beverages and tobacco earlier about produced goods, and that seems right, does it not?
A. It may be right, yes.
Q. Well, they are your data series, so I am trying to understand what data series you have chosen to use.

But, again, similar weighting problems where the product is largely imported is going to be different between the different CPI and PPI, and I suggest actually that is magnified as a problem when we come to look at restaurants, because restaurants are likely to have very different food purchasing patterns from food and drink retailers, are they not? There are just certain products, like breakfast cereals, that supermarkets may sell a lot of, but I would not think there are many restaurants selling large portions of that, so the weightings are going to be different again?
A. Possibly, yes.
Q. I suggest to you, again, this is just a very poor proxy for restaurants' food costs, is it not?
A. Well, it is best proxy that is available.
Q. You say it is the best one, but sometimes it just not a very good one at all. Using something that is so bad it is, you know, just not providing any real guidance. That is not, you know, best, that is just simply inadequate?
A. Well, I think the point is you are suggesting that there is going to be some sort of radical difference between the way in which these different food products change in price over time, and I am not sure if that is the case.
Q. Well, that is the issue, is it not? We simply do not

know whether that is the case.
A. Yes.
Q. So your analysis is based on there is an inherent uncertainty in it?
A. Well, there is always an uncertainty in any type of analysis of this type.
Q. Now, the second part of your composite index is the average weekly earnings data. That is for accommodation and food services activities. It is average pay, but also it includes data and things like hotel employees. So it is, again, not a measure of the costs of -- restaurants' labour costs, is it?
A. Well, again, I think the -- as I said earlier, I think the point is what is the labour market from which people are drawn who work in restaurants? I would think it is quite plausible that there is a big overlap between the labour market in which restaurants draw their employees and the labour market from which hotels draw their employees.
Q. But the actual cost they incur is going to be the kind of -- type of staff they employ. There may be an overlap with some staff; it is a question of the ratios of staff is what is going to impact upon average costs in a particular sector?
A. Well, I do not -- I think that -- I think that this is

likely to be representative for restaurants. I do not really see why you would expect there to be a big difference between the evolution of wages in people working in hotels and people working in restaurants.
Q. The problem is all it provides us with data on is evolution of wages, not evolution of labour costs, so that headline data just does not tell us anything about how the cost of labour to restaurants changes, because you do not know how many staff are being employed based on that data?
A. So your point is there might be a volume effect that is not being captured?
Q. Yes.
A. Yes.
Q. Now, if we look at, then, the analysis that you do, which is at paragraph 4.104 {RC-F/10/172}. It is particularly paragraph 4.104(b) that I wanted to ask you about, because one key modelling choice that you make here is the decision not to include a time trend in this model.
A. Yes.
Q. Now, you state in paragraph 3.175(d), if we can go there, at page 114 of your report {RC-F/10/114}. So if we can go up, it is paragraph 175 at the top of the page, (d). Can we go back over the page, it might be

a wrong reference. (Pause)

I will simply put the proposition to you. I am not sure I have the paragraph reference. It is right, is it not, that you decide whether or not to include the variations? Your stated position is you do say, based on whether or not they are statistically significant to include in the model, that is your ...

A. Well, that is part of the decision, but also one has to think about the economic significance and the plausibility of including the control.

Q. In this case, if we go back to paragraph 4.104(b), which is on page 172 {RC-F/10/172}, you say you have not included a deterministic time trend; it was statistically significant, was it not?

A. It was, yes.

Q. Why is that not made clear in your report, that you have taken a different approach from elsewhere of excluding something which is statistically significant?

A. I have explained here why I have not included the time trend.

Q. Well, this is a deviation from the approach you have taken everywhere else. Is that not something you felt you should make very clear, that you were excluding something which was statistically significant, when everywhere else that is the approach you say you take to deciding what goes in the model and what does not?

A. Well, as I say, it is not just a question of deciding whether something is statistically significant or not, one has to think about the economic significance and the plausibility of including the control.

Q. When you say "plausibility", I mean -- well, I suppose firstly let us look and see what the impact of this is. If we go to Ms Webster's reply report at {RC-G/13/61}. It is 134(a). Ms Webster explains in the restaurant sector:

"... Mr Coombs excludes his time trend ... despite finding it to be statistically significant, and therefore in contradiction with his own methodology."

She talks about your explanation, which we will come back to.

Then at the end of the paragraph:

"Consistent with this, I find that Mr Coombs' lower bound pass-on elasticity estimate for entertainment falls from 0.91 to 0.35 with the inclusion of a time trend."

If we go down to footnote 144, Ms Webster then explains that based on your price-cost ratios:

"... this implies that the pass-on rate would fall from [114%] to roughly 44%."

So this is a really substantial impact that you are

having on the results, is it not, Mr Coombs?
A. Yes.
Q. Again, why are you not making that clear in your report, that you are having such a dramatic -- that you are making a change contrary to your standard approach and it is having such a major impact upon the outcome of your analysis?
A. Well, what I do is I explain the reason why I have decided not to include the time trend.
Q. I have now found the reference, or my learned junior has very kindly given me the reference. If we go back to 3.175, and it is subparagraph (b), not (d) so page {RC-F/10/113}, which is where you explain the approach that you say you are going to take.
So 3.175(b):
"I test whether the (restricted) time trend variable tends to be statistically significant ... If it is insignificant, I consider the model without a time trend to be the most suitable. If it is significant, I include the restricted time trend in the analysis."
So your stated approach to all of this is you apply your statistical test. If it is statistical -- irrelevant -- statistically significant, you include it. If it is not, you do not. So you are going against your entire stated methodology here without mentioning it or

explaining the impact it has?

A. Well, I explain at paragraph 4.104 why I have not included the time trend, which is because of the -- because of the interaction between the time trend and the price measure here.

Q. Let us look at your explanation then. It is 4.104(b) {RC-F/10/172}.

You say you have excluded it on the basis that:

"... the cost index is very highly correlated with the time trend, so including a time trend ... [makes] it very difficult to reliably estimate the pass-on elasticity, especially the CPI for restaurants tended to increase at a constant rate over the period."

But, I mean, on the face of it, that will just simply be a reason to include -- it is showing something which is potentially highly relevant to the pass-on issue, is it not?

A. Well, if you look at the -- if you look at the graph on the previous page, so on page 171 {RC-F/10/171}, figure 11, you can see what is happening here. So the red line is cost and the dark blue line is price, and then the light blue line, which is a straight line, is the time trend. So the problem that you have is that if you look at price, it goes up very closely with the time trend over time. So if you include the time trend, what happens is that essentially price just becomes determined by the time trend. So effectively you have a model in which you are saying that somebody who is running a restaurant sort of wakes up in the morning, looks at their calendar, decides what the date is, and on that basis they set the price, rather than actually taking into account cost.

So the model really just does not work. It produces a price which is determined purely by the date, which has no economic basis, that people would just set prices based on the date without any reference to costs at all. So that is the problem with including a time trend, because it just produces a model that makes no sense.

Q. If we go then to Ms Webster's report, {RC-G/13/61}. We saw this in relation to numbers. In the middle of the paragraph:

"... the collinearity between the time trend and Mr Coombs' cost measure may itself demonstrate the relevance of the time trend by showing that Mr Coombs' cost measure is likely to be highly correlated with ... omitted factors that are increasing over time and explain variation in the price measure."

So that -- the possibility here is you -- you know, it very well may that the time trend is showing us something very relevant, and you are simply excluding it

when it is statistically significant?
A. Yes, but the question is what is the economic rationale here for including the time trend, if you end up with a time trend explaining everything and costs having virtually no effect on prices? It is a sort of economically impossible result. Also, going back to the previous studies that you showed us, Mr Cook, it is inconsistent with results of previous studies as well.
Q. Well, not necessarily inconsistent but it still -- if you make -- if you include it, it still gives you a pass-on rate of 44%. It certainly does not give you the pass-on rate that suits Mr Merricks. That is the objection, is it not?
A. Well, I think the -- as I say, the issue here is actually having a model that makes sense and produces a plausible relationship, and including a time trend it just -- you end up with a model that just makes no sense.
THE CHAIRMAN: Can I ask you: did you run the model including that time trend?
A. I am sure I must have done, yes.
THE CHAIRMAN: Right. But you do not mention the results of doing that?
A. No. I mean, to be honest I cannot remember, but I am sure I probably did run it with the time trend, yes.

THE CHAIRMAN: Okay.
MR COOK: I mean, you say it does not give an economically rational result. I mean, you are basically starting from the premise that there is going to be high pass-on everywhere, because that is the only reason why a result of 44% is not, you say, economically rational. There is nothing that inherently suggests that is an unrealistic figure?
A. Well, we have the results of previous studies which, as I say, I used as a cross-check on my results. So using them as a cross-check, it tends to suggest that a result of 44% is unlikely.
Q. Well, you say the previous results. The previous results are talking about the pass-on of taxes to on-trade alcoholic beverages. You also had a result for football tickets, which you now say you do not rely upon. I mean, the only result previously was alcohol, which we know from previous cases is perhaps a slightly special case, or an area where there is particularly high levels of pass-on.
A. But is also something which is sold by restaurants, so it is clearly relevant in this case.
Q. Yes, but the vast majority of what they are selling is not alcohol. So the mere fact -- and they are obviously selling it in a completely different kind of

marketplace. They are not selling it in a situation where people are, you know, competing necessarily on prices, which is why we all know that bottles of wine in restaurants are a lot more expensive than buying exactly the same product from a supermarket. You are somewhat a captive audience at that point, are you not?

A. Well, I think you are suggesting that a pass-on rate for alcohol somehow is not relevant to the restaurant sector, which I find surprising that you would think that.

Q. Well, I am not suggesting it is not relevant. I am asking you about your analysis and saying -- your reasons for thinking that 44% was unrealistic, such that you decided not to put those numbers forward at all.

A. Well, as I say, I made a modelling choice about what seemed to be the most sensible way of modelling the relationship between costs and prices in this case, and taking account of the fact that the model needs to be economically plausible.

Q. What you mean is it needs to give a high number?

A. No, not necessarily that it needs to give a high number, but it needs to make sense.

Q. If we look at one of the other adjustments you made, which is 4.104(d), on page 172 {RC-F/10/172}, you say:

"I have also included a dummy variable to control for the large percentage changes in the restaurant retail price that occurred in April 2008 and January 2011."

Then you estimate a version of the model including and excluding that variable.

If we go to figure 11, at page 171 {RC-F/10/171}. Looking at it, you do not see any sort of particularly dramatic increase in prices here?

A. Yes, it is difficult to -- well, you have 200, more than 200 observations here, so it is difficult to see the effect of an individual price spike on the graph.

Q. Well, what led you to identify those two specific months as being ones that needed the time dummy when nothing else did?

A. Well, it was inspection of the data that identified that those are two significant price increases which are much larger than you get in any other months in the data.

Q. What was the threshold you used for that? What kind of percentage increase did you say was exceptional?

A. Well, they are multiple times larger than any other price increase.

Q. If we look and see what results you get when you actually apply this, so if we go on to your bounds test, which is at Table 36, page 172 {RC-F/10/172}. So what we have here is two sets of results, one includes your

dummy months and one does not include your dummy months. We see that in the heading at the top for these two dummies. Just to clarify what we get, if you include your dummies, you do not even meet the 10% bounds test threshold, do you?
A. No.
Q. No. So, I mean, your dummies do not really achieve anything there at all, because the results with them are just -- you know, it is not reliable at all, is it?
A. No, it produces -- well, it fails the bounds test, you are correct. I think the point is that, you know, what it shows is that actually if you correct for them, you end up with -- well: two things. One is you actually end up with a lower estimate for pass-on. The other thing is that it means that you pass the test for serial correlation and heteroskedasticity.
Q. But with a number that is not statistically significant at any of the accepted normal levels?
A. No, but it is -- well, I am illustrating what happens when you do include these dummies in the table.
Q. Yes. But the end result is you get something which is not statistically significant?
A. Yes.
Q. Then if we turn to the alternative, which is without the dummies, so alternative 2. Now, you do pass the bounds

test at 10% here, but you do not pass either of the test for serial correlation or the test for heteroskedasticity?

A. Yes. I think the point is that the other model is illustrating why it is that you fail the test for serial correlation and heteroskedasticity, it is because of the presence of those outliers. So, I mean, maybe just stepping back. So heteroskedasticity is to do with residuals in the model. So when you have an econometric model, the model produces a prediction of what, in this case, prices are going to be and then you have the real prices and the real prices are always slightly different from what the model predicts and the difference between the two is the residuals. So when you have heteroskedasticity, it means that those residuals, their variance is not constant over time so they -- the variance of those residuals changes, and then that affects the reliability of the statistical test, which I think is the point Mr Cook is making.

Generally, when you fail, what you often do is you look to see, well, is there a particular thing that is driving this, is there a particular problem that is causing this variance? One of the things that can do that is when you have these type of outliers. So, you know, if you have these outlier results, then it drives up the residuals at particular points in time.

So that is what I am testing for here. I basically test for whether that is -- these residuals, these outlier observations, are driving the fact that there is heteroskedasticity in the model and what I find is that that is the case, is that when you actually control for these outliers, then you remove the heteroskedasticity from the data. So that is effectively what I am doing here.

Q. Once you remove those outliers, you pass heteroskedasticity but you do not have a statistical relationship -- a statistical significant relationship?

A. Well, you have -- you do not have a statistically significant relationship. That is not to say that there is no relationship at all. It is just that the relationship is not statistically significant.

Q. So you just do not know if there is a relationship?

A. Well, I think you have to be -- you have to be careful being too sort of binary here. So it means that you do not have -- you do not have strong evidence of a statistical relationship, but you do still have some evidence of a statistical relationship.

Q. You have not identified what other probability or what other test threshold would have been met for this. What was it?

A. No. Well, by convention, you test, as I said, at 1%, 5% and 10%.
Q. So, looking at this, you either have something which does not -- is not statistically significant by any of the accepted thresholds or one which you can make be statistically significant by picking those two out but then does not pass the test for serial correlation or heteroskedasticity, both of which are pre-conditions for the bound test being reliable?
A. Yes. So if we go to page 173, paragraph 4.106c {RC-F/10/173}, the third line there is the conclusion I reach. So I conclude that there is some statistical evidence. So I am not saying that there is a statistically significant relationship; I am just saying there is some statistical evidence of a long-run relationship between prices and costs. So it is, you know, a carefully worded, nuanced conclusion there.
I think the point is that the fact that you do not have a statistically significant relationship does not necessarily mean that there is no relationship at all. It just means --
THE CHAIRMAN: You mean you cannot come up with a reliable estimate?
A. Well, it means that your estimate is less reliable than it would be if you did find a statistically significant

relationship, but it does not necessarily mean that the relationship is not there. It still actually means that your estimate is the best estimate of the relationship. It just means that there is some uncertainty about the reliability of that relationship, but it is still your best estimate of what the relationship is.

PROFESSOR WATERSON: How much uncertainty in this case? I mean, what -- would it include zero, for example?

A. I do not know the answer to that question.

MR COOK: If we look at 4.106c and d, the problem is that what you say in c is, you say:

"... the model that does not include [the] dummy variable passes the bounds test ... so I conclude that there is some statistical evidence ..."

But you do not make the obvious connection with subparagraph d, which is that is not statistical evidence because the result of the bounds test is unreliable, once you fail the test of serial correlation and heteroskedasticity.

So you just do not have any confidence, any sort of reliability in relation to either of the versions of the model you produced, do you?

A. Well, as I say, I think one needs to avoid being completely binary about this. The fact that it fails the bounds test does not mean to say that there is no relationship. It just means to say that, you know, the evidence is -- the evidence is weaker, but the estimate that you produced is still your best estimate.

Q. Why do you not set out clearly that none of the statistical modelling you have done here produces a statistically reliable number?

A. Well, I have -- well, I think I set out the results in the table and in the text.

Q. If we go back to the table at Table 36 {RC-F/10/172}, there is also an adjustment coefficient you calculate in relation to this, and you see those numbers there. You explain over the page what that adjustment coefficient relates to in this context, or what it shows in this context and that is at 4.106b {RC-F/10/173}. You explain the adjustment coefficient is between .4% and 1.4%, indicating the restaurant subsector price adjusts by approximately .4% to 1.4% each month towards the long-run equilibrium following a deviation. So this is how long or a measure of how long pass-on takes. Is that a fair --

A. Yes.

Q. So at .4% per month, I mean, basically I understand that basically is a residual so every time you do 4%, then it is 4% of what is left and then .4% of what is left?

A. Yes.

Q. Yes. I understand that will take over 500 months for 90% of the pass-on you have calculated to be reflected in prices.
A. Yes. Well, I do not -- I will take your word for it that that is correct, but, yes, it is a very slow adjustment.
Q. Yes. I mean, that is over 40 years, so twice the Merricks claim period?
A. Yes.
Q. Even at 1.5% -- 1.4%, it will take over 160 months for 90% of the pass-on to have occurred. That is 13 years. Again, do you not think it is important to make clear in your report that your pass-on numbers are going to be taking basically a decade-plus, decade or decades to work their way through? Is that not a very critical thing to make clear in your analysis?
A. Well, I have repeated -- you are quoting from my report so, you know, I have set out the result there in the table and then I have set out in the text the interpretation of those numbers, what they mean.
Q. But you then produce an economy-wide pass-on rate that simply applies the numbers, without taking any account of the fact that your analysis indicates those numbers will take potentially twice as long as the Merricks claim period to work through?

A. Well, again, we come back to the question as to, you know, what are we trying to do here? We are trying to produce our best estimate of pass-on for this sector. So I am saying this is my best estimate of pass-on for this sector.

Q. It is very important to say, is it not, that after five years there will only be 20% pass-on -- the numbers, I am just making up off the top of my head -- but after five years there will be 20% pass-on, after ten years, there will be 40% pass-on. I mean, that is very dramatically different from saying there will be 114.5% pass-on throughout, is it not?

A. Well, as I say, I have set out the results in the table and I have explained them in the text.

THE CHAIRMAN: From that sentence, certainly someone in my position would not get from that what you are actually saying, namely that it will take a very long time for that pass-through to happen, but that is what you are saying?

A. Yes.

THE CHAIRMAN: All right. Okay.

MR COOK: What we are looking at in this context, as we saw, is basically at best a sort of measure of COGS. So, I mean, it has a labour element to it, but you are looking at sort of the input costs of food, alcohol and

then a labour element, so it is COGS-plus perhaps.
I mean, the labour element is probably somewhat variable by reference to the amount of people who sit in your restaurant?
A. Well, it is --
Q. So even with COGS, you are identifying something that will take potentially decades to work its way through?
A. Well, it is COGS plus a labour cost.
Q. Now, in terms over pass-on rate, you make the familiar adjustments at paragraphs 4.107 for the retailer mark-up, effective VAT rate -- I am not going round those houses again -- and give your figures of 114 to 127. Again, you do not really address the fact that those are materially above 100% and you do not identify any reason to think the exceptional circumstances in which you get pass-on above 100% apply in this sector, do you?
A. Well, I use -- in practice I use the lower of those estimates, 114.5%, so that is, you know, above 100%, but not very significantly above 100%.
Q. Now, let us look at what you do then in relation to considering temporal extrapolation in relation to this, and we will come back to sectoral extrapolation in a moment. In terms over temporal extrapolation, we can see your analysis at Table 37, which is at 4.117

{RC-F/10/176}. So you set out the results again for your two different versions and then you say:

"I conclude that the estimated long-run pass-on elasticity is not substantially affected by the exclusion of later years ..."

If we look at the table, we will notice that there are two asterisks or one asterisk next to each of the sensitivity numbers. Do you see those? We can see the asterisk indicates that the bounds test is not passed in a given specification. So, in terms of that, it is slightly misleading on the basis that we also know that some of your baseline estimates did not pass the bounds test or did not pass the other tests, but these sensitivities do not pass the bounds test at all either, do they?

A. No.

Q. So how can you conclude that the long-run pass-on elasticity is not substantially affected by the exclusion of later years when you are relying upon data that is just not robust to anything?

A. Well, it goes back to the point that I made earlier about the fact that you do not pass the bounds test does not mean to say that there is no information in the estimate that you have produced and these estimates are very similar to the estimates -- to the baseline

estimates is the point that I am making here.
Q. The whole part about the statistical testing you are doing is to try and identify whether you are identifying -- whether there is a confidence element that what you are identifying is a genuine relationship, as opposed to just the fact that, as we all know, most costs and prices have gone up over the last 30 years. So, you know, merely the fact that both have gone up in itself tells you very little. You need to have a relationship between them to draw any conclusions about pass-on, do you not?
A. Yes. Well, I have reported the fact that I do not pass the bounds test so, you know, that is --
Q. I am just putting it to you --
A. -- that is --
Q. -- you do not have a basis for drawing any form of conclusions about -- you say:
"I conclude that the estimated long-run pass-on elasticity is not substantially affected ..."
I do not see how you can draw conclusions when you just do not have any robust analysis for a single one of the numbers on that table.
A. Well, as I say, that is the, you know -- what I am doing is I am testing to see whether the numbers change and the numbers do not change materially at all. That is

the conclusion that I am drawing.

Q. Why do you not say in your report here, "I have tried to do this, but, I am sorry, there is just no robust analysis that can be done here"?

A. Well, then what does one do? It is a throw up our hands in despair so, you know, the alternative that we have here is merchant data so data from -- well, I will not go into too much detail about the merchant data, but there is merchant data available here and other experts who have looked at that merchant data have found significant problems which mean that they seem to effectively find that that merchant data is unusable in order to produce a pass-on estimate for this sector.

So, you know, if we then throw up our hands and say, "Well, it is impossible to estimate the pass-on for this sector", then, you know, where are we? You know, my instructions were to do my best to estimate the level of pass-on and that is what I am trying to do.

Q. So, as far as you were concerned, it did not matter if you did not have robust outcomes, you were going to come up with a number in any event?

A. Well, I produced my -- this is my best estimate. I have set out the results. I set out whether or not it passes the relevant test and then I say: well, this is the, you know, best estimate that I have for this sector, despite

the caveats that are attached to it.
Q. If we then look at paragraph 4.119 {RC-F/10/177}. You have -- that sets out figure 12, which is the evolution of retailer mark-ups, again with some of the issues we talked about before, but you conclude, based on that, that what that shows is a steady fall in restaurant margins over time from over 20% at the start of the period in 1996 you have data for down to, you know, sort of realm of sort of 10-15% by the end of the Merricks claim period and thereafter.
You conclude, based on that, that that means it is likely that you may be overestimating the pass-on rate that applied to the early years of the Merricks claim period, do you not?
A. Yes.
Q. So, again, you would accept an adjustment is appropriate, you just cannot put a number on it there?
A. No, but what I do is I used the lower of the two estimate.
Q. Well, you do. You say in your report at 4.122 {RC-F/10/178} that you are being conservative in using the lower range of the figures. You are not being conservative in adopting lower figures in circumstances in which both are known to be statistically unreliable?
A. Well, I believe I am being conservative in the sense

that I have two estimates and I have used the lower one.
Q. Going back to the issue of sector extrapolation, you have dealt with this in paragraph 4.112, page 174 {RC-F/10/174}. So, having produced your restaurants data, you say:

"I ... consider the extent to which my estimated Pass-on Rate for the Restaurants ... can be extrapolated to the Entire entertainment sector."

You say that previous studies also relate mostly to the pass-on of retail prices of food and beverages. You say one study by Szymanski, and you have confirmed already you do not rely upon that, so, I mean, looking at that, you just do not have any basis really for reading it across at all, do you?
A. Well, I do. So -- well, two things to say. First of all, in terms of the read across, so I have produced an estimate for the restaurant sector. If we go back and look at what are the other sectors or subsectors here --
Q. Let us go to 4.113, subparagraph b, and work our way through the different subsectors or you work your way and I will ask you some questions about it.
A. Yes. Well, so essentially the point that I make is that if you look at the other large subsectors, such as cinema, theatre and dance, sports and games establishments, so part of the revenue that these people

gain will be from selling food and drink on the premises. So there is some overlap between their revenues and restaurants.

We then have public houses, which is the sort of fifth largest segment, and public houses is essentially identical to restaurants. So in fact the definition of the CPI here would effectively include public houses within this within its definition. So, therefore, there is some overlap or -- well, put it another way: the estimate that I produce, I think it covers more than 50% of this sector. It is not just the restaurant sector. It covers also public houses and it covers some of the revenues in some of these other parts of the sector.

Q. But, looking at the core business then, gambling, you know, I mean, the odd casino may have a bit of in-house catering. There is obviously all sorts of other gambits of the gambling industry, bookies, slot machines, all areas like that, where there is not any form of food element and even where there is, it is going to be relatively small, so you just do not have any basis to read across a restaurant pass-on analysis to gambling establishments generally, do you?

A. Well, it comes back to the question about what is the best available evidence for these other subsectors? You know, we do not have -- well, at the time I was writing my first report, you know, I did not have any other evidence. I did not have evidence from merchant data for these other subsectors. When I came to write my second report, Mr Holt produced an estimate for public houses which in some ways had already, as I say, overlapped, but I did a cross-check to see what happened if I used for his estimate for public houses and it did not materially change my estimate.

But in terms of when I was writing my first report, I did not really have any other evidence for these other sectors and there does seem to be some degree of overlap between the restaurant sectors and these other subsectors so this seemed to be the best evidence that I had.

Q. If we go over the page to --

PROFESSOR WATERSON: Can I just raise an additional point about this sector, which is it strikes me, but you may or may not know the answer to this, that this is a sector -- entertainment is a sector where there have been big changes in what people do in the form of entertainment over time. So attendance at football matches is much lower at the beginning of your period, the Merricks period, than it is now. Attendance at cinemas was much higher, etc. So the mix has changed a lot in this sector?

A. Well, the mix has changed to some extent -- well, I mean, it is maybe a good point that you raise, Professor Waterson. So actually restaurants were a bigger proportion of this sector at the beginning of the period that I am looking at, so the data that I am looking at -- let me find the table. So this is Table 32 on page 166 {RC-F/10/166}. So this data goes back to January 2005 and actually the restaurant sector was a higher proportion. I think it was pretty much exactly 50% back in 2005. So if that trend had continued back further, then restaurants actually would have been a bigger proportion of this sector in the earlier years, during the Merricks claim period, than it is shown by this table. That is the one thing I do know from looking at how things change over time.

PROFESSOR WATERSON: Thank you.

MR COOK: In relation to the restaurant percentage point, of course what took place between 2005 and 2010 was the global financial crisis which is likely to have impacted quite significantly on discretionary expenditure, restaurants being an obvious example of very discretionary expenditure, so there is no reason to think that is a general trend so much as just simply a financial crisis effect. Do you agree?

A. Sorry, I did not understand the point.

Q. I am saying you have -- you are pointing to the fact that the proportion of expenditure in restaurants fell between 2005 and the 2010 and I am pointing out to you that the global financial crisis happened in that period, that impacted inevitably on discretionary expenditure and restaurants are an obvious example, so that -- the explanation for that fall may simply be the global financial crisis, not some longer term trend?

A. That is possible, although the only thing I mention is that when I tested for the impact of the financial crisis in my model, I found that it did not have a significant impact.

Q. Well, there might not be a significant impact in terms of pass-on rates but that is different in terms of whether, you know, there was a contraction in the number of restaurants in the market?

A. Yes, that is possible.

Q. So that was your restaurants point. So when, if we go to paragraph 4.114 {RC-F/10/176}, and you say:

"... I expect the Pass-on Rate for Restaurants ... to apply to a significant majority of card expenditure in the Entertainment sector."

Is that just referring to the fact that some of those sectors may also sell food?

A. Well, it is also referring to the fact that the

restaurant sector may have been a bigger portion of this sector in the earlier years of the Merricks claim period.
Q. So it is referring to those points?
A. Yes.
Q. It is not saying -- you are not concluding here that your pass-on rates for restaurants applies to the core business of gambling places, cinemas, theatres, dance, sport and game establishments?
A. I am not saying it applies to them. What I am saying is there is some overlap in terms of what they do and what restaurants do and therefore, on that basis, the restaurants -- my pass-on rate does not just apply to the 46.5, but will apply to some of the revenues of these other businesses and that that 46.5 probably was higher during the earlier years of the Merricks claim period. Those are the two points.
Q. Okay. Sorry, I think you sort of cut off in the middle of the sentence. You are not saying it applies to their core business, are you?
A. No.
PROFESSOR WATERSON: Presumably restaurants include McDonald's, Burger King, etc, that do not sell alcohol?
A. Yes.
PROFESSOR WATERSON: They may be -- I do not know -- in the

majority of expenditure?
A. Yes, I do not know.
MR COOK: Sir, I think that is the end of entertainment. I am going to move on to another sector. Hopefully we are speeding up because there are obviously themes that --
THE CHAIRMAN: So what is the plan, are you going to go through all the sectors? They followed a fairly similar form.
MR COOK: Well, I am obviously planning to, you know, make it shorter as it goes on, but we only have -- we are four out of the six that are public data, but I will certainly be much shorter tomorrow.
THE CHAIRMAN: Right. Are you using this table or is this just for our own entertainment?
MR COOK: Sir --
PROFESSOR WATERSON: Bedtime reading!
MR COOK: Yes. Sir, the utility -- the reason for producing the table is just a checklist of the various different bits of the data.
THE CHAIRMAN: I understand.
MR COOK: So obviously the closings will make submissions about where you get in different bits of it, but it is a convenient way of saying: okay, those are the indexes, these are the adjustments that have been made in that

sector, here are the margin things and the various points that arise in relation to them. So I am not planning to -- it is more of a checklist for the convenience than actually being something that I am cross-examining by reference to.

THE CHAIRMAN: Right. So what are you saying we should -- we can break off now or do you want to move on to --

MR COOK: Well, I am saying I am well ahead of where I expected to be at this point, sir.

THE CHAIRMAN: Right. So are you anticipating -- I mean, on the timetable you have eight and a half hours.

MR COOK: Yes. I will not be --

THE CHAIRMAN: You are not going to be using all of that so you should be finished by lunchtime tomorrow?

MR COOK: That is what I anticipate, sir.

THE CHAIRMAN: Okay. Then --

MR BEAL: If that is the case, and this may be ambitious, we may need to ask Mr Harman to attend on Wednesday afternoon.

THE CHAIRMAN: Wednesday. So you think you will be shorter than a day?

MR BEAL: No, I think I will be a day, but if I start at lunchtime tomorrow, then --

THE CHAIRMAN: I follow, yes.

MR BEAL: -- Mr Harman will be up at the crease on Wednesday

afternoon at some point.
THE CHAIRMAN: So Visa has 0.3 hours.
MR BEAL: I am sorry, yes, I forgot about that.
THE CHAIRMAN: Are there points of contention between you and Merricks?
MS BOYD: We may have no questions to put, sir. We have a reservation of 20 minutes in case there are points because there are some divergences of approach, although, as you understand, the overall thrust of where they end up is similar.
THE CHAIRMAN: Okay. Obviously you can only put questions in cross-examination where there are contentious issues between you and Merricks.
MS BOYD: Of course. Of course, sir, and it may be that we have no questions that we wish to put, but at the moment I am not in a position to assure you of that.
THE CHAIRMAN: No, I understand.
Right. So do we start with the next one or we can safely call it a day for today?
MR JOWELL: Well, I am in the Tribunal's hands, of course, but, yes.
THE CHAIRMAN: Well, I think we would probably prefer that.
MR COOK: You have had enough fun for one day, sir, so that was my expectation.
PROFESSOR WATERSON: I am just getting into the swing of

things!

THE CHAIRMAN: Well, you can carry on!

All right, 10.30 tomorrow. Thank you.

(4.22 pm)

(The hearing adjourned until 10.30 am
on Tuesday, 3 December 2024)