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IN THE COMPETITION
APPEAL TRIBUNAL

Case No. 1146/3/3/09

Victoria House,
Bloomsbury Place,
London WC1A 2EB

25th October 2010

Before:

MARCUS SMITH QC
(Chairman)

PROFESSOR PETER GRINYER
RICHARD PROSSER OBE

Sitting as a Tribunal in England and Wales

BETWEEN:

BRITISH TELECOMMUNICATIONS plc

Appellant

– and –

OFFICE OF COMMUNICATION

Respondent

– and –

(1) CABLE AND WIRELESS UK
(2) VIRGIN MEDIA LIMITED
(3) GLOBAL CROSSING (UK) TELECOMMUNICATIONS LIMITED
(4) VERIZON UK LIMITED
(5) COLT TECHNOLOGY SERVICES

Interveners

*Transcribed from tape by Beverley F. Nunnery & Co.
Official Shorthand Writers and Tape Transcribers
Quality House, Quality Court, Chancery Lane, London WC2A 1HP
Tel: 020 7831 5627 Fax: 020 7831 7737
(info@beverleynunnery.com)*

HEARING
(Partial Private Circuits)
DAY FOUR

APPEARANCES

Mr. Graham Read QC, Mr. John O’Flaherty and Mr. Ben Lynch (instructed by BT Legal) appeared for the Appellant.

Mr. Pushpinder Saini QC, Mr. James Segan and Mr. Hanif Mussa (instructed by the Office of Communications) appeared for the Respondent.

Miss Dinah Rose QC and Mr. Tristan Jones (instructed by Olswang) appeared for the Interveners, Cable & Wireless UK, Virgin Media Limited, Global Crossing (UK) Telecommunications Ltd, Verizon UK Limited and COLT Technology Services (the “Altnets”).

1 THE CHAIRMAN: Good morning.

2 MR. READ: Good morning, sir. As you will recall, I was halfway through my cross-examination
3 of Mr. Myers. You asked, if you recall at the start of the hearing, for the figures to be
4 redone in respect of para.124 of Mr. Myers' witness statement and a copy of that has now
5 been produced and provided which should be inserted at the point in the statement at p.
6 525a, as you can see from the page numbering.

7 MR. GEOFFREY RICHARD PLATT MYERS

8 Cross-examined by Mr. READ (continued)

9 Q Mr. Myers, we were discussing on Friday afternoon return on capital expenditure and I just
10 want to briefly touch on four further points. Firstly, do you accept that in fact on BT's own
11 figures it was substantially above the DSAC ceiling for the period 2004/2005.

12 A Can you give me the reference?

13 Q Perhaps if I ask you to look in core bundle 2 which has your witness statement in, and go to
14 the back in tab 31 (which is the Final Determination). Go to table A12.2 which starts on
15 p.1018. Do you see that? Do you see that these actually are the adjusted figures that BT
16 has supplied? If you look at the 2 Mbit/s tranche you see the total revenue is given as £98
17 million, and the DSAC ceiling is given as £147 million. Do you see that?

18 A Yes.

19 Q So on the figures that BT have provided 2004/2005 was actually above the DSAC ceiling.
20 That is clear from those figures, is it not?

21 A Yes.

22 Q The only reason it goes below the DSAC ceiling (and we can see this not in terms of figures
23 but in terms of percentages at p.1024 which is table A12.4) in 2004/2005 is because of the
24 adjustments that Ofcom did in the Final Determination?

25 A Yes, that is my understanding.

26 Q It is clear from those figures, is it not, because here you see that actually it is now only 94.8
27 per cent of the DSAC ceiling?

28 A Yes, the point I was just mentally checking was whether this table includes internal as well
29 as external sales, because there was a difference in price between internal and external sales
30 in 2004/2005.

31 Q Yes, I see. So you are quite right, we do not actually have anywhere, the figures, do we, for
32 what the adjusted DSAC ceiling was?

1 A Yes, that is in the Determination, the DSAC for external sales after adjustments and
2 compare that to the price charged externally. Those figures will also be in my witness
3 statement.

4 Q I see. Anyway, I do not want to spend a long time on this. The short point is that
5 effectively what happens is that as a direct result of Ofcom's adjustment, the figures come
6 just below the DSAC ceiling?

7 A Yes.

8 Q So if, for example, the figures had not quite gone as far as they did in Ofcom's adjustment,
9 they could still be above the DSAC ceiling?

10 A Yes, that would be possible.

11 Q So, really, your whole approach of this period of 2004 to 2009 depends ultimately on the
12 reduction having brought BT's revenues just below the DSAC ceiling for that year
13 2004/2005?

14 A Sorry? Are you saying 2004/2005 or for all years?

15 Q No. Let me take you back, so that there is no doubt about what I am actually asking you.
16 You say, do you not, in para.124 of your witness statement (let me put the point and then
17 see whether we need to turn it up) very clearly that you should exclude 2004/2005 from the
18 equation because BT's prices were actually not above DSAC and therefore you say you do
19 not take them into account for the purposes of repayment?

20 A No, that is not quite correct. That is consistent with what I say, but I say that Ofcom did not
21 find a breach of cost orientation in that year and therefore it is irrelevant, it is not just about
22 price being below DSAC but obviously that was part of the reasons why Ofcom came to
23 that conclusion.

24 Q The short point is, is it not, Mr. Myers, that if BT had been just a bit higher in its revenues
25 after Ofcom's adjustment, so they were above the DSAC ceiling, you would have been
26 forced to take that year into account, when you came to do your calculations as regards the
27 repayments?

28 A When you compare price and cost you use, as a matter of good practice, you use the best
29 available figures to estimate both price and, indeed, cost, and often that involves the
30 Regulator applying adjustments to the regulated firm's figures, because there was often a
31 difference of view about some detailed issues of costing, so you use the best available
32 information.

1 Q That is my point, you see, you have deliberately excluded 2004/2005 from your calculations
2 and what is wrong, we say, with using that piece of information to see what the results of
3 your adjustment actually are?

4 A Well it depends on the question that is being addressed. The question that was being
5 addressed by these return on capital employed figures in the determination, and which I
6 comment in my witness statement, was it was about the effect of the determination in the
7 context of repayments. In that context, since Ofcom did not find overcharging in
8 2004/2005, and there was no repayment required in that year, it seemed appropriate to
9 exclude it.

10 Q And that depended almost entirely on the fact that BT's revenues for 2004/2005 had just
11 gone under the DSAC ceiling?

12 A Yes, that was a key part of the evidence for this conclusion that there was not overcharging
13 in that year.

14 Q The next point I want to ask you about, as we explored on Friday and I do not want to take
15 you back to it in any great depth, you ignore any adjustment to BT's revenues when you
16 come to consider the effect of the repayments?

17 A Sorry, could you clarify the point?

18 Q You ignore adjusting BT's revenues down to the DSAC levels for the purposes of
19 considering the issue or repayments?

20 A Yes.

21 Q Or indeed anything within the context of the final determination?

22 A No, that's not correct. For the purpose of repayment, yes, that's true, and looking at the
23 effect of the determination, the determination did not require the repayment from one part
24 of BT to another, so it is excluded from the rate of return on capital employed in that figure,
25 but as I recall on Friday I took you to table 3 in my witness statement and the figures
26 highlighted in bold are the ones included in the determination and those include return on
27 internal as well as external sales.

28 Q Because you would accept, would you not, that actually the whole of BT's Regulatory
29 Financial Statements spend a great deal of time distinguishing between external and internal
30 revenue?

31 A That is a key issue, yes.

32 Q It is an obvious point, in fact it is fair to say because I think we have the 2005/2006 ones in
33 the bundle – or had them in the bundle – but in fact it is not quite so clear in the Regulatory
34 Financial Statements until 2007/2008, but in any event you agree. Let us just have a very

1 brief look at it, because there has been another set of, I am afraid, Regulatory Financial
2 Statements in the bundles. It is additional bundle 1. I think it may be the clip that you
3 actually have there, sir.

4 THE CHAIRMAN: The clip marked 2A.

5 MR. READ: Yes, sir. That is going into ADB1 Do you have that clip there, Mr. Myers?

6 A 2A, yes.

7 Q I do not want to spend long on this but just to familiarise ourselves with it, could you go to
8 p.33. Here we see a terminating segment up to and including 8Mbit/s. Do you have that?

9 A Yes.

10 Q We can see from the first column that it deals with internal services also provided
11 externally, and internal sales only provided internally, which, as you can see, has no entries
12 in it. Then external sales – yes?

13 A Yes.

14 Q And if one looks at p.53, one sees, as an illustration in respect of fixed public narrowband
15 networks, the same formula. There is a very clear division between internal sales and
16 external sales – yes?

17 A Yes.

18 Q And at p.60 do you see the same division in respect of trunk? We can go through numerous
19 examples in the accounts, but what it is showing is that, certainly by 2008, and I think the
20 same may have been true for 2007, internal and external sales were religiously separated in
21 the Regulatory Financial Statements.

22 A Yes.

23 Q So my point is that when you came to do your calculations in para.124 as to the rates of
24 return, it is really completely inconsistent with the whole way that the Regulatory Financial
25 Statements have been structured if you do not split it out in the same manner?

26 A It's not inconsistent, because they're looking at different analytical questions, as I made
27 clear already this morning, in fact. The return on capital employed, as used by Ofcom, and,
28 in my view, the only appropriate use of that number, because it is aggregated across both
29 terminating segments and trunk segments, it is inappropriate for the purposes of assessing
30 overcharging itself. Ofcom only assess that aggregated rate of return in the context of
31 repayments. So in that very specific context, where the repayment applies retrospectively, it
32 clearly doesn't affect prices in the past. It is merely a transfer. If in accounting terms there
33 had been a repayment from the relevant part of BT Wholesale to the relevant part of BT
34 Downstream, that would simply have been a pure transfer of revenue or profit from one part

1 of BT to another. It would not have affected any downstream price that was actually
2 charged. That's a different circumstance from non-discrimination as it applies in a forward
3 looking way.

4 Q The whole point about para.124, Mr. Myers, with respect, is that you are criticising the
5 figures that Mr. Budd has produced – yes?

6 A Yes, because I explained that, for the purpose of assessing repayment and looking at the
7 effect of this determination, I made those two points, that 2004/05 should be excluded and
8 the hypothetical repayment should be excluded. For different purposes, for different
9 analytical reasons, a different approach might well be more appropriate.

10 Q When he was citing those figures in his first witness statement he was looking at it about the
11 question of whether there was overcharging in the first place?

12 A I don't recall precisely, but I do recall that I was quite careful to say that I was looking at it
13 in the context of the effect of the determination on the repayments.

14 Q I think we have probably drawn the battle lines between us as much as we can on that point.
15 Would you accept this, that the CPs, the communication providers, use a different mix of
16 trunk to the way that BT uses it?

17 A That's my understanding, yes.

18 Q Would you accept, for example, that the Edinburgh to London trunk example may very well
19 be a very bad example for the purposes of considering the likely effects of any overcharging
20 on trunk?

21 A Could you take me to the relevant reference, please?

22 Q Certainly. If you go the Final Determination at para.4.102 at p.838. (Pause)

23 A I am sorry, could you repeat your question, please?

24 Q Yes. Let me do it by reference to the paragraph you have just read. The paragraph you
25 have just read presupposes a London to Edinburgh trunk route as opposed to, for example
26 say, an Edinburgh to Glasgow trunk route, yes?

27 A Yes, it gives that as an illustrative example, yes.

28 Q The point that I am putting to you, Mr. Myers, is that on the evidence there is, that is more
29 likely to have been a BT trunk segment, i.e. Edinburgh to London, than it is for one of the
30 other CPs?

31 A I'm not sure I have sufficiently -- I mean, I understand the general point that I've seen from
32 the evidence that on average BT will tend to buy longer circuits from its upstream
33 operations than other CPs will, but I don't have sufficient knowledge of the precise detailed
34 evidence to know whether there are examples of CPs buying routes of this length.

1 Q Can I just ask you to take core bundle 1. Turn to tab 10, which is Mr. Budd's first
2 statement. Go to para.13 p.310. I do not want you to refer to the figures. I hope you see
3 from this they are actually marked "confidential". But you can see that in fact it is giving
4 the rates of return earned by BT in providing PPCs to CPs as opposed to PPCs to CPs and
5 BT. Do you see that?

6 A Yes, across both terminating and trunk segments aggregated.

7 Q And it is fair, is it not, looking at those figures, to say that they are different to the overall
8 figures, if you look at BT providing PPCs to everyone - CPs and BT?

9 A Yes, that's my recollection; they are different.

10 Q So again, I put the point that if you are looking at the return on capital expenditure figures,
11 it makes no sense to include the BT revenues in your calculations as you have done in
12 para.124?

13 A I did actually cover this point on Friday. I mean, first of all, we were looking at rate of
14 return for the purpose of assessing overcharging, in my view it's inappropriate to aggregate
15 across trunk and terminating segments. In the assessment you look at the trunk segments on
16 their own, and I believe these figures will be in table 3 in my witness statement. As I
17 explained, if one looks at p.504 bundle 2. I think the point I made on Friday was that the
18 upper part of the table shows the rate of return on 2 Mbit trunk for both internal and external
19 sales, and the lower part of the table is for external sales only. There is in fact either no
20 difference at all or almost no difference between the two for the years 2005/2006 onwards,
21 and for the year 2004/2005 it'd actually be misleading, if one were using it to assess
22 overcharging, to rely on 2004/2005 because there was a distinctly different price between
23 internal and external sales in that year, and so it would be more relevant, if one was
24 assessing the external price, to look at (iv) than (i) in that particular case. I say it doesn't
25 make a difference.

26 Q On the basis of this table, you would say if you are looking just at external sales you should
27 be excluding 2004/2005 in any event?

28 A No, I don't think I said that. I said that if one were using rates return to assess overcharging
29 then one should look at overcharging to external CPs and external sales. It would be more
30 relevant to look at row (iv) than row (i), but that only really makes a difference for
31 2004/2005 and it doesn't make any material difference to any of the other years.

32 Q I understand that you want to obviously rely on a table that shows different figures, but do
33 you not think it is a very blinkered way of looking at things to ignore the rate of return on
34 capital expenditure figures that Mr. Budd has produced in his witness statement?

1 A For the purpose of assessing overcharging?

2 Q For the purpose of assessing overcharging.

3 A No, I don't think that's blinkered; I think that's taking an appropriate approach to the nature
4 of the evidence that's relevant. 2 Mbit trunk price, in my view, is clearly an economically
5 meaningful price signal, and it would be, in my view, misleading actually to aggregate it
6 with terminating segment prices, or indeed terminating segment rates of return for the
7 purpose of assessing overcharging on 2Mbit trunk. Indeed, I would suggest that in the
8 particular circumstances that apply here, it's particularly misleading to do that aggregation,
9 because we have terminating segment rates of return under the separate terminating segment
10 price caps which are actually relatively low, the rates of return on 2 Mbit trunk which are
11 extremely high. By aggregating them one simply obscures actually both of the rates of
12 return on each of those underlying services. As I say, the key point is that the trunk price
13 and the terminating segment price in their own right are economically meaningful.

14 Q We are back to the same point, are we not, about whether you should aggregate or
15 disaggregate the trunk elements?

16 A Yes, that's an important point, I agree.

17 Q I have lost a page reference. Just bear with me for one moment, Mr. Myers. (After a pause)
18 I am sorry to keep shifting you around, but the little clip of papers that you had which have
19 the Regulatory Financial Statements in, which I think have got into everybody's ADB1, tab
20 2A, and if we go back to p.33, which we briefly touched on earlier when we looked at this
21 document, which was dealing with terminating segments up to and including 8Mbit/s, can
22 you see that?

23 A Page 33, yes.

24 Q If we have a look at some of the figures, for example, if one looks at "Main link fixed
25 charge per year" do you see that?

26 A Yes.

27 Q And if we look to the right hand side, three columns in from the right, we can see the
28 "Unaudited LRIC Floor", can we not? Do you see that?

29 A Yes.

30 Q And we see it is £106.08 - yes?

31 A Yes.

32 Q I am looking now at the "Main link fixed charge", that is the third row down?

33 A Yes.

34 Q If I have understood these correctly the average price is £66.99?

1 A Yes, that would be my understanding of these figures.

2 Q So well below the LRIC floor?

3 A Yes, that's correct.

4 Q Or DLRIC floor, so we are just clear about what we are actually talking about. Likewise if
5 we go down the page we see "Partial and Private Circuits 64K/bit/s – local end" (second
6 row up from the bottom) and then we see an "Unaudited LRIC Floor" of £414.23, and an
7 average price of £248.56. Likewise, for the "Local end fixed charge" £414.24 and an
8 average price of £322.80 - yes?

9 A Yes.

10 Q So both of those again below the DLRIC floors?

11 A Yes.

12 Q So do you think it is still right to say that you should ignore what is happening in the
13 terminating segments when you are considering trunk?

14 A Yes, I do, because as I said the trunk segment price is an economically meaningful price,
15 which was defined as a separate market from terminating segments, which reflects the fact
16 it is an economically meaningful price, subject to distinct and regulatory obligations. The
17 charges you are taking me to here are charges that were controlled under the terminating
18 segment price cap which was set in 2004 would still have applied in this year. So this is an
19 issue that arises under the terminating segment price caps. To the extent this is a concern it
20 should be addressed within that separate context from trunk segment pricing.

21 Q I think the battle lines are drawn between us on that. Can I finally ask you on the ROCE
22 issue, you had a set of calculations, I think, forwarded on to you on Friday night, did you
23 have a chance of seeing those at all?

24 A Yes, I did, yes.

25 Q This is the RPI minus X point that I was putting to you. I do not want to go back over it
26 because obviously you have dealt with why you say this is not a good example on Friday,
27 but can I just check with you that the figures are agreed, the actual arithmetic of the figures
28 are agreed?

29 A I agree the arithmetic of the calculation, I just have one actually minor point of clarification,
30 which was, I believe it was 18.8 per cent real terms price reduction in Mr. Morden's witness
31 statement. In going into his witness statement I didn't see any calculation to derive that and
32 the paragraph in which it appears discusses price reductions on 140 and 155Mbit/s as well
33 as 2Mbit/s trunk, so I was not quite certain whether or not that 18.8 per cent real terms
34 price reduction related only to 2Mbit/s or other trunk band widths as well.

1 Q But subject to that?

2 A Subject to that minor point I agree the arithmetic.

3 Q Can I ask you now to return to the historical background to all of this? You accept, I think
4 in 2004 Leased Lines Market Review, and the final statement in September 2004, the whole
5 of that process Ofcom assumed that the trunk prices were expected to signal the scope for
6 entry in the expansion of the trunk market and to be constrained by the threat of entry and
7 the pressure of competition. That was the assumption that led Ofcom to effectively setting a
8 more relaxed control on the trunk segment and a price control on the terminating.

9 A I think it was the latter aspect of what you just said rather than the former, i.e. that Ofcom's
10 view in 2004 was that whilst BT had SMP, and had SMP for the forward looking period of
11 the market review of two to three years, that Ofcom expected the degree of competition on
12 trunk routes to increase and for that to provide some constraint on pricing – views which
13 have turned out to be incorrect.

14 Q Yes, effectively that it was going to be prospectively competitive, albeit that it did not
15 ultimately turn out to be that?

16 A That's not quite correct. The term "prospectively competitive" as it was used in 1997 meant
17 something quite specific, which was that BT had market power at the time, but that was
18 expected to be eroded within the forward looking period. As I have said actually in 2004
19 trunk was not prospectively competitive in that sense because BT not only had SMP at the
20 time of the review, but was expected to retain it for the forward looking period of that
21 review.

22 Q Can I ask you to go to core bundle 2, tab 31 and look at p.826, para. 4.41 of the Final
23 Determination?

24 A Yes.

25 Q You can see there that it is setting out what Ofcom's approach in the 2004 LLMR was and
26 adds:
27 "In particular, the trunk price was expected to signal the scope for entry and
28 expansion in the trunk market and to be constrained by the threat of entry and the
29 pressure of competition."
30 Yes?

31 A Yes, I agree.

32 Q What it effectively means is that it is going to become prospectively competitive. It may
33 not be competitive at the moment, it may not be competitive for the next two years but by

1 the end of the period it is going to become competitive, or at least be constrained by
2 competitive pressures?

3 A I agree with your general point, I was just being precise in the use of the term
4 “prospectively competitive” which actually is not quite correct but I agree that Ofcom’s
5 expectation in 2004, its analysis, which turned out to be incorrect, but its analysis was that
6 competition would increase in trunk segment market.

7 Q I do not want to take you through a long trawl of the documents but I might just ask you to
8 refer to one, which is the original March 2001 direction dealing with the offer of PPCs. Can
9 I ask you this question, were you involved in that process at all?

10 A I don’t recall I had a close involvement in it.

11 Q Sorry?

12 A I don’t believe I had a close involvement in that, but I don’t have a very clear recollection.

13 Q In that case I will not take you further on that. Can I ask you about your secondary tests,
14 because you agree, do you not, that there was a series of secondary tests that were
15 introduced in the course of the final determination that were never specified in the original
16 1997 and 2001 guidelines?

17 A There is a drafting difference in that in the final determination it was structured in the way
18 you have described, but the first order test was as previously elucidated and the further
19 factors, which you are referring to, I think, as the “secondary tests” were kind of set out in
20 terms of that was the approach Ofcom was going to adopt. Most of the elements of those
21 secondary tests were referred to or discussed in the draft determination with the exception, I
22 think, of the circuit analysis which BT provided in response to the draft determination, and
23 with the exception of the assessment of whether prices below DSAC might represent
24 overcharging, which I think I explained on Friday came about also in response to views
25 expressed in comments made on the draft determination by the CPs.

26 Q It always been accepted, has it not, that the guidelines do not provide, Ofcom says, a clear
27 definition of what further practice should be taken into account beyond the first ordered test
28 of DSAC or DLRIC?

29 A Well, the guidelines, as we discussed on Friday, refer to the effect on consumers and
30 competition, and that is obviously one of the secondary tests. The guidelines also referred
31 to stand alone costs and combinatorial tests, which is also one of the secondary tests. But
32 beyond that, I agree, the further secondary tests that were considered relevant in this
33 particular case were not articulated in the guidelines.

1 Q How is somebody trying to comply with a cost orientation obligation supposed to know
2 exactly what they are required to do if the secondary tests are not actually laid out clearly in
3 those original guidelines?

4 A Well, I'm not sure that there's anything terribly unpredictable in the tests that Ofcom used.
5 The first order tests were set out in the guidelines. Stand alone costs and combinatorial tests
6 were referred to in the guidelines, discussed in the guidelines, the effect on competition and
7 consumers was, as we discussed on Friday, referred to in the guidelines. Beyond that, the
8 tests that Ofcom used were the rate of return on a fully allocated costs basis, which is
9 actually a very standard part of any analysis of profitability or price cost tests. The further
10 elements discussed were actually in response to the specific evidence or points that were
11 submitted by BT in its attempt to explain why its charges were justified.

12 Q Nowhere in the 1997/2001 Guidelines, for example, does it talk about the magnitude and
13 the duration of exceeding DSAC, does it? There is nothing in there about that?

14 A As I recall that, you're correct.

15 Q So when, for example, you come to lay down the magnitude and duration of the amounts by
16 which the charges exceeded DSAC, that was something new, was it not?

17 A That was a further elaboration, yes, but again, I really don't see there would be any
18 difficulty in predicting that that would be a sensible thing to do. Whenever one is dealing
19 with price cost tests, it is usually meaningful to look over a period of years, particularly if
20 the period one is looking at covers a number of years, the extent of price above cost and the
21 degree of persistence of price above costs are absolutely normal considerations one would
22 take into account in doing this kind of analysis.

23 Q You accept, because this is what we went through at some length on Friday, that DSAC is
24 not a proxy for stand alone costs and combinatorial testing?

25 A That's correct, yes.

26 Q They are totally different concepts, in fact, are they not?

27 A Well, they have a relationship, but they are different concepts.

28 Q A bit like one is a cat and one is a dog, if you like?

29 A I'm not sure I'd use that analogy, but they are different concepts.

30 Q There is a big difference between them?

31 A They are different concepts, yes.

32 Q The consequence of that is that if you do not clearly set out what exactly is going to be the
33 effect of exceeding DSAC, how is somebody supposed to understand what they are to do in
34 making sure that their prices are cost orientated?

1 A As we discussed on Friday, the guidelines specify that DSAC provides an effective first
2 order test for the likelihood of anti-competitive or exploitative charging. Given that
3 context, I would expect that a regulated firm exceeding DSAC would have identified for
4 itself, in compliance with its cost orientation obligations, good reasons why, despite failing
5 that effective first order test, nevertheless there was not that adverse effect, and that
6 evidence could come in a number of forms, as indeed BT submitted evidence during
7 Ofcom's investigation.

8 Q Let us have look and see what actually we are talking about here in terms of figures. Could
9 you go to p.1015 in that core volume 2 bundle, again it is the Final Determination, tab 31,
10 p.1015, and we are looking now at table A12.1. We do not have the figures there for
11 2004/2005 for 2Mbit/s trunk. Do you see the 2Mbit/s trunk row?

12 A I see that, yes.

13 Q If we look at 2005/06, and I am just concentrating on 2Mbit/s trunk, we see that there is a
14 total revenue of £260 million and a DSAC ceiling of £136 million. Do you see that?

15 A Yes.

16 Q The next year, 2006/07, the revenues have gone down, but the DSAC ceiling has gone up –
17 yes?

18 A Yes.

19 Q And the following year, 2007/08 revenues go down and the DSAC ceiling nearly halves on
20 its previous year?

21 A I think it's more illuminating to look at the unit DSAC figures, if we look at table 2 in my
22 witness statement.

23 Q I know you like table 2, and you want to keep coming back to it, but I am looking at the
24 absolute figures here that are in the Regulatory Financial Statements.

25 A But I'm just pointing out, in table 2, that uses the same underlying – well, actually, not quite
26 these underlying figures, because these figures were the ones originally published by BT, so
27 they were subject to the errors in BT's accounting for revenue, as I understand it, and so
28 were subject to BT's re-statement. Table 2 shows the figures that were used by Ofcom in
29 the determination. If we look at the unit external DSAC it does have that pattern you
30 described in terms of you can't compare 2004/05 with 2005/06 because they are prepared
31 on a different basis, as it explained in footnote 55. But from 2005/06 to 2006/07, there was,
32 as you say, an increase which is shown in the increase in the unit external DSAC and then a
33 significant decline in 2007/08.

1 Q: Mr. Myers, are these figures in BT's Regulatory Financial Statements? They are not, are
2 they?

3 A I'm not ----

4 Q: Whereas the figures in table A12.1 are, because that is where they have come from?

5 A But if one was looking at price versus costs, which is fundamentally what cost orientation is
6 about, it's more meaningful – in my view, it is easier to understand what is going on to look
7 at the unit price and the unit costs than to look at totals. But I agree, it does depend on the
8 purpose for which one is looking at numbers, which is more useful to understand.

9 Q BT publishes its information in the Regulatory Financial Statements. That is the material in
10 A12.1. That is the material that BT has been asked to publish by Ofcom, and that is the
11 material upon which, if it is possible, BT has to base its pricing?

12 A I'm not sure this is really a point of contention. As we saw, just looking at the example of
13 pages you showed me before, you were actually taking me to examples of the unit price, the
14 average price in the year and the average cost, whether that was on a fully allocated costs or
15 a DLRIC basis or a DSAC basis. One can express these numbers in either way whether
16 they appear on the face of the accounts, which I believe in many years they would have
17 done on that unit basis where you look at the totals. I mean, there isn't really a substantive
18 difference between them. The issue really is which is more meaningful and which is more
19 useful to look at for the purposes of any particular analytical question.

20 Q Mr. Myers, just so we are clear, I am looking at this from the practical point of view of how
21 BT is supposed to set its prices based on these Regulatory Financial Statements?

22 A And so am I, because it's ---- It is absolutely straightforward for BT to compute the average
23 price. It knows the total revenues and it knows the volumes. It is a trivial calculation to
24 derive the average price. It knows the total costs in £ million, and it knows the volumes.
25 Again, it's a trivial calculation, one over the other, to derive the unit costs. I'm slightly
26 unclear what the point of substance between us is. It doesn't seem to be a point of
27 substance to me at all.

28 Q Let us just go back to table A12.1, and see if I can help you on this. If we just look again at
29 2006/2007 which is on p.1016. Just look at 2006/2007 as opposed to 2007/2008. We see
30 that the DSAC ceiling nearly halves in its amount, does it not? It goes from £154 million to
31 £83 million.

32 A Yes.

1 Q If you have that sort of price variation within a year, how is BT to anticipate that in fact the
2 costs for the next year, for the year in 2007/2008, are going to fall so drastically that its
3 DSAC ceiling is nearly going to halve?

4 A Because I would expect BT to have an understanding of its own costs, and it shouldn't be
5 reliant on the publication. It should know what is happening to its own costs before the
6 Financial Regulatory Accounts published at that year end. If we look at Table 2 in my
7 witness statement on p.502, and in particular if we look at the bottom row which shows
8 DSAC as a proportion of fully allocated costs - fully allocated costs being a figure that BT
9 might more normally track as part of its normal accounting - we can see that actually DSAC
10 as a proportion of fully allocated costs is a relatively consistent ratio apart from 2006/2007.
11 So I can see that there was perhaps a slight oddity in 2006/2007, but in terms of 2007/2008,
12 the ratio between DSAC and fully allocated costs returns to its more normal level of 175%
13 or thereabouts. So if BT had an understanding of movement in its fully allocated costs and
14 an understanding, as it should have done, of the relationship between Distributed Stand
15 Alone Costs and Fully Allocated Costs, I would expect it to be able to form a reasonable
16 view on what costs movements might look like. I would also expect it, in terms of
17 compliance, to take account of the extent in the prior year by which it had exceeded DSAC.
18 As we can see, for 2007/2008 in 2005/2006 the price was 62 per cent above DSAC and 26
19 per cent above in 2006/2007. Those would clearly be relevant factors. I would expect BT
20 to take into account in judging how it should vary its trunk prices in order to ensure
21 compliance with cost orientation.

22 Q I am going to come back to that in a moment, but just while we are on Table 2, what it is
23 actually showing, is it not, is that BT's prices are becoming more and more efficient over
24 time?

25 A I'm sorry?, it's showing that the excess of BT's prices as a DSAC is in fact increasing
26 substantially over time and becoming less efficient.

27 Q Less efficient. This is in a period when Ofcom itself accepts that BT's efficiency has
28 improved.

29 A Sorry, we must distinguish between efficiency of pricing, which relates, in economic
30 concepts, to the concept of allocative efficiency, and the point you are just referring to,
31 which is about costs and productive efficiency which is a quite different concept. My
32 comment about efficiency of pricing was relating to allocative efficiency, and that relates to
33 the relationship between price and cost. As we can see from this table, there was a

1 substantially widening gap between price and costs over this period, even if BT was
2 improving its productive efficiency in general.

3 Q Anyway, to go back to the point that I was talking about, Mr. Myers, you accept, do you
4 not, that BT cannot fix its DSAC ceiling and its DLRIC floor until it has had very clear
5 guidelines set out by Ofcom as to how actually it is going to approach certain costs?

6 A Well, that goes to the absolute precision of the number; that does not mean that BT cannot
7 take a sensible view on adjustments that Ofcom is likely to make, or indeed that the scale of
8 those adjustments did not, I don't believe, change the general picture. If one looks at the
9 general picture of the excess of BT's revenues above DSAC using Table 12.1 the precise
10 numbers would be different from the percentage differences shown in Table 2, but the
11 general pattern I believe would be relatively similar.

12 Q BT, when it is looking at 2006/2007 to set its prices, could not really be expected to
13 understand that the following year its DSAC ceiling would almost halve, could it?

14 A As I've said, I would expect BT to have an understanding of its own accounting information
15 and the reasons why. I mean, for example, I don't know the precise reason why there was
16 this increase between 2005/2006 and 2006/2007, but I would expect BT should have an
17 understanding of whether that's due to an accounting distortion, a quirk, some costs, for
18 example, the benefit of which arises over a period of years that have been written off being
19 accounting for solely in that year, or whether it actually reflects a true underlying cost
20 difference. If, in 2006/2007 it was due to some of these so-called accounting quirks or
21 distortions from the point of view of true economic costs, then I would expect BT should be
22 aware of that and the fact that that distortion might well be unwound or relatively unwound
23 in subsequent years including 2007/2008. If we look from 2005/2006 to 2007/2008
24 (ignoring for a moment the 2006/2007 figure), it is the 2006/2007 figure that looks like it
25 may well be the outlier. But, as I say, I would expect BT to have a good understanding of
26 why its accounting information turns out the way it does, and to take that into account.

27 Q Could I ask you just to take bundle ADB3 tab 5. We have the Regulatory Financial
28 Statements for 2005. Do you see that?

29 A Yes.

30 Q If you look at p.18 at the bottom of the page you see: "Cost of copper" and saying Ofcom
31 issued two consultation documents in late 2004 and early 2005 concerning the valuation of
32 Local Access Network assets with the intention of issuing a statement in summer 2005. It
33 goes on to talk about the review of the valuation of copper Local Access Circuits. Those

1 are the sort of changes that Ofcom are discussing with BT to its Regulatory Financial
2 Statements, are they not?

3 A I think this cost of copper was an unusually major issue. But yes, there are year on year
4 issues, perhaps not of this scale. But I'm not quite sure how this affects the general picture.
5 Those discussions between Ofcom and BT are to understand what the impact of what
6 Ofcom has proposed or indeed what BT proposes, how any particular new approach to costs
7 should be taken into account. Those discussions are precisely - one of their reasons being to
8 allow BT to have an understanding of Ofcom's thinking. That is one of the reasons why we
9 have an open, consultative process, and to allow BT to take a view, a reasonable view. Of
10 course, this is in 2004/2005. You were earlier discussing with me the change between
11 2006/2007 and 2007/2008, which I doubt was related to this point about cost of copper.

12 Q It may well not be, but I am not, in a hearing of this length, going to get into detailed issues
13 about the accounting. I am simply making a general point, Mr. Myers, that effectively it is
14 Ofcom who have a huge hand in telling BT how to derive the DSAC ceiling cost, is it not?
15 That is a consultative process that goes on from the end of the year end until the Regulatory
16 Financial Statements are actually published?

17 A I mean, in this specific case there were adjustments that Ofcom made to BT's figures, but I
18 can't recall the precise magnitude of them. But, as I said before, I don't recall them being
19 abnormally large in this particular case. I think if one looks at the figures before
20 adjustments one would derive the same general picture, although there would be points of
21 difference detailed between the picture of price versus costs before and after Ofcom's
22 adjustments.

23 Q Can I just move on to a slightly separate point, Mr. Myers. We started this by talking about
24 the magnitude and duration tests that Ofcom introduced in the secondary tests in the Final
25 Determination. Effectively, would you agree that the testing that you actually introduced at
26 that stage in terms of magnitude and duration was somewhat different to the testing that you
27 had introduced in the draft Determination?

28 A Yes, the draft Determination effectively discussed duration and extent. I don't recall the
29 precise changes, but there was some difference in detail, I believe, between the draft and the
30 Final Determination which may well have been reflecting responses that were received to
31 the draft Determination.

32 Q So, for example, if we go to p.1024 in the second core bundle, in the Final Determination at
33 flag 31 we see for 140/155 Mbit/s for the Local End Component, which is in the
34 penultimate row box on that page, do you see that about a third of the way down?

1 A Yes.

2 Q We see Local End and we see that for 2006/2007 it said 130.4 per cent, and in 2007/2008 it
3 is 116 per cent, is it not?

4 A Yes.

5 Q So above DSAC for those two years. So if you applied a test of looking at whether or not
6 DSAC ceiling is being exceeded for two years, that, Local End 1440/155 Mbit/s would have
7 failed that initial DSAC test. Do you agree with that? That is obvious from the figures.

8 A The first test, yes.

9 Q Do you also agree that in the draft Determination there is no mention at all about the Local
10 End 140/155 Mbit/s potentially failing cost orientation?

11 A I'm sorry, that's not a point of detail that I recall. I would have to review the documents.

12 Q In that case I will not ask you about it, because it is in the material in any event before the
13 Tribunal. Can I move on to Combinatorial Testing? We looked on Friday in the draft
14 Determination about the original suggestion in Annex 13.13 that it was not possible to do
15 this within the short timeframe of the dispute resolution process. Do you remember being
16 taken to that?

17 A I recall that, yes.

18 Q Would you agree that on any view combinatorial testing has been done in a period of under
19 a year?

20 A Yes, I believe that's the case.

21 Q We know that from some of the material that Mr. Pigott has exhibited. Perhaps we ought to
22 have a look at that. Do you want to clear your desk and put away all bundles apart from
23 core bundle 2. Can I then ask you to take bundle BT2, some way into that bundle there is
24 not a tab numbered as such, but the document I want you to go to is with the tab ESP10. If
25 we go to that, it is a letter from Oftel dated 14th April 1998. You have that one, do you?

26 A Yes, I have it.

27 Q As I say, it is a letter from Oftel dated 14th April 1998. Go to the end of that letter. We
28 actually see it is a letter from you?

29 A Yes.

30 Q If we go to the third page of the letter there is a specific section dealing with combinatorial
31 tests, is there not?

32 A Yes.

1 Q There an annex A setting out levels 1 to 4 tests for international network: “As regards the
2 floors, we expect this merely to provide confirmation of our discussions ...” and at the
3 Annex we see the combinatorial tests that were being expected. Correct?

4 A Yes.

5 Q So this is 14th April 1998. If we go on to the next tab in the bundle, which is ESP12, it is a
6 letter to you from Mr. Pigott. At the end of it there is an agenda for the meeting for LRIC
7 methodology and included within that one can see that there is a specific item dealing with
8 combinatorial tests in respect of international services. Do you see that?

9 A Yes.

10 Q Then finally, just to complete that, at ESP 13, there is another letter from Mr. Pigott, it is
11 not to you this time, but it is to Mr. Greenfield, it is dated 22nd June 1998, and if we go to
12 the fourth page of that letter ----?

13 A Sorry, where ----

14 Q It is tab ESP13.

15 A Yes, I have it.

16 Q A letter of 22nd June 1998, and if we go to the fourth page of that letter, we see
17 “International Combinatorial Tests”,
18 The disclosures set out in the schedule were agreed in principle.”
19 So there does not seem to have been too much of a problem resolving the issue of what
20 combinatorial tests were to be done in respect of this particular item, was there?

21 A I don’t recall the details, but yes, there is an exchange of correspondence.

22 Q Can I ask you now to put that bundle away and take out bundle DF3, and ask you to go to
23 tab 4, which is the National leased lines review in 2000. Do you have that?

24 A Yes.

25 Q If you can turn to page 3, and when I say “3” I mean the rubber stamp 3 at the bottom of
26 the page (the internal reference is “iii”), but I am going to refer to the rubber stamp at the
27 bottom, which is “3”. We can see from para. S2 that: “In November 1999, “OFTEL
28 announced it was launching a review into the state of competition”?

29 A Yes.

30 Q If we go on in the bundle to p.54, annex B, there is a specific discussion about stand alone
31 costs and combinatorial testing?

32 A Yes.

33 Q Then, for example, on p.56, at B12, we see an example of combinatorial testing being
34 carried out?

1 A Yes.

2 Q And this document is published in August 2000 and, as I say, we noted earlier on that it was
3 only in November 1999 that Oftel announced that it was going to undertake this review, so
4 in the space of , at most, 10 months – probably less, Oftel felt fully in a position to carry out
5 combinatorial testing?

6 A This was a very high level combinatorial test in relation to, I believe, leased lines as a
7 whole, which is less complicated than for an individual service and, as I recall, Ofcom also
8 did not ultimately rely on these combinatorial tests because of the difficulties of doing them.

9 Q Where do we find that?

10 A My recollection is that is in the PPC Phase 1 direction.

11 Q Is that the one we have just been looking at, the March 2000 – sorry, which direction?

12 A This will be 2002, I think.

13 Q The Phase 1 direction?

14 A The Phase 1 direction – which bundle would that be in?

15 Q That would be in bundle AB1. Tab 1 is the Phase 1 direction, tab 2 is the Phase 2 direction.

16 A I cannot recall whether it was the Phase 1 or Phase 2 direction. (After a pause) Yes, it is in
17 the Phase 1 Direction document, para. C.65, p.101 in that document.

18 “It would be possible to further analyse BT’s rate of return on leased lines via
19 combinatorial test, but such a study would require detailed information on all the
20 costs that are common between leased lines and other parts of BT’s regulated
21 business and would imply examining the profitability of these other parts of BT
22 which share costs with leased lines. Earlier work on this issue, contained in the
23 Leased Lines Review, indicated that there are considerable uncertainties in
24 making this calculation for retail leased lines. Consequently, the Director has not
25 undertaken analysis of this sort.”

26 Q This is in the context of the introduction of PPCs, is it not?

27 A That’s correct.

28 Q And you are saying that the Leased Lines Market Review was done at a very high level?

29 A No ----

30 Q “Combinatorial tests were done at a very high level” I thought you said?

31 A I am making two points. First, the combinatorial test was done at the level of leased lines as
32 a whole. There was one specific combinatorial test that you took me to in that market
33 review document, which was looking at combinations of leased lines and PSTN services,
34 and taking a specific approach in order to take about of the fact that PSTN services were

1 charged controlled, an issue that I have flagged up as something that requires adjustment in
2 my witness statement. That is the point about it being at a high level. Ofcom in that
3 document identify a further test which was still at this high level of leased lines as a whole
4 between leased lines and other data services, which it had not conducted at that point in that
5 review, and this paragraph – my understanding is – is explaining that, that further
6 combinatorial test was difficult to undertake, and consequently in this document there
7 seems to be no reliance in the combinatorial test and the analysis of profitability appears to
8 relate just to return on capital employed.

9 Q ROCE?

10 A ROCE, yes, which is the table on p.100.

11 Q I am not in a position to specifically deal with what that document is saying at the moment,
12 although I may take some instructions on it later, but whatever the case the reality is that
13 combinatorial testing can be done but it may not necessarily give the complete answer?

14 A Combintorial testing can be done; I have never suggested it cannot be done and, depending
15 on what it examines it may be informative, or it may be uninformative. It has to be looked
16 at on a case specific basis.

17 Q The problem is that if a party is to actually know what combinatorials are required, it needs
18 to be told what they are, does it not?

19 A On the contrary, it is clear that the most important combinatorial test, the whole point of
20 combinatorial testing is about recovery of common costs, where common costs are shared
21 with other services, therefore it flows directly from that underlying economic theory that the
22 most relevant combinatorial test to look at therefore, would be between services that share
23 the greatest proportion of common costs and, as we have seen from BT's analysis of the
24 stand alone cost of 2Mbit/s trunk segments, by far the largest proportion of common costs
25 relate to sharing of those other costs with other increments, such as the access increment
26 and a relatively small proportion of costs is shared between trunk and terminating segments,
27 so in my view it would have been quite clear what the important combinatorial tests would
28 be and what the relatively less important ones would be.

29 Q Let us just explore that a bit, shall we? Can I ask you first of all to take BT1 and if I can ask
30 you within that to go to tab 5.1, which is BT's response to the draft determination of 5th
31 June - yes?

32 A Yes.

33 Q If we go to p.30, para. 52?

34 A Yes.

1 Q It sets out:

2 “As already indicated above BT has conducted a number of combinatorial tests

3 since receiving the Draft on 27 April 2009. An explanation of the methodology

4 used in deriving these estimates is provided in Annex1. BT is prepared to

5 consider any further tests suggested as appropriate.”

6 Footnote 39:

7 “BT would have been more than prepared to consider doing these tests had it

8 realised that Ofcom intended so radically to depart from the dispute as framed in

9 the Olswang Dispute Submission and the RGL report and that Ofcom intended to

10 engage in such a detailed enquiry into the dispute. For all the reasons that BT has

11 already given, BT considers this detailed enquiry to be inappropriate but, even if it

12 is accepted that it should have been conducted ...”

13 It goes on to say that Ofcom should have conducted these combinatorial tests. Well we can

14 have a dispute about whether Ofcom should or should not have done combinatorial tests,

15 but what is clearly being said at para. 52 is that if there are any further tests that are

16 considered to be appropriate BT is happy to do them, yes?

17 A Yes.

18 Q Now we know there was a meeting, because Mr. Budd refers to it in his statement, on 1st

19 July 2009, and Ofcom raised the issue of a combinatorial test across BT’s Core services,

20 which BT then did?

21 A I do not believe I was present at that meeting so I do not think I can speak to it.

22 Q As I say, it is in Mr. Budd’s statement. BT did that and, indeed, we will see it in just a

23 moment, if I can ask you then to put BT 1 away and go to BT3, and 11.2, that is a letter

24 from Ofcom to BT, dated 15th July?

25 A Yes.

26 Q And it is talking about the stand alone cost model and the use of combinatorials. It refers

27 specifically in that first paragraph to the meeting on 1st July. It says in the second

28 paragraph:

29 “However, we believe that in the context of whether or not you should undertake

30 further tests is appropriate for us to indicate that we have significant reservations

31 about the weight that can be placed on the results of the methodology.”

32 Yes?

33 A Yes.

34 Q Then it sets out a number of issues, but it says in terms at the end of that paragraph:

1 “Most importantly, we very much doubt that it will be feasible for BT to address
2 these concerns within the timeframe of the disputes.”

3 Do you see that?

4 A Yes.

5 Q Over the page – I do not want to be accused of not putting anything to you – it says, the
6 fourth paragraph down:

7 “The implication of the Guidelines is that combinatorial tests would, in principle,
8 need to be carried out for every combination of services that share common costs
9 with 2Mbit/s trunk services. This would therefore encompass more services that
10 just other PPC trunk and terminating services. Given the way that BT allocates
11 common costs and service components, this potentially could involve BT needing
12 to carry out combinatorial tests in relation to many or even all the services
13 provided across the entire BT Group. Clearly this level of analysis is enormously
14 difficult to carry out in practice, as it involves billions of different combinations.”

15 So the reason being given at this stage is quite plainly that there are just too many tests to
16 do?

17 A No, this letter covers the point about the concerns. The concerns referred to in the sentence,
18 “Most importantly it would be feasible for BT to address these concerns”, certainly the
19 number and selection of combinations, but it includes the other points in the letter on costs
20 modelling and also, as we see, conceptual concerns. There are a number of conceptual
21 concerns identified there. One of them, as I recall in the first paragraph under “conceptual
22 concerns” deals with the point that was caught in the determination service identification, to
23 question that if a combinatorial test has failed and still it’s not clear cut which service was
24 responsible for that overcharging. So there are a number of concerns being identified here,
25 of which the number and selection of combinations is certainly an important issue, but
26 certainly not the only issue.

27 Q No, and it is fair to say that you have headed it “Conceptual concerns”, and in the second
28 paragraph it says:

29 “Another concern is the unintended risk of imposing rate of return regulation when
30 combinatorial tests across multiple services are considered.”

31 A Yes, that’s a problem with combinatorial tests.

32 Q The whole point, as I understand it, is that you now say that the tests that need to be done
33 need to be done higher up the BT hierarchy, and if you do that do you not then run foul of
34 the very point that is being made in this letter about ----

1 A I agree with you, these are fundamental or serious, certainly serious, problems with using
2 combinatorial tests in this case. So the logic is as follows: as I said, the important
3 combinatorial tests relate to services that share the largest proportion of common costs. In
4 this particular case, as we have seen from the numbers, although I believe they're
5 confidential, a very large proportion of the common costs relevant to 2Mbit/s trunk are
6 shared with services in other increments, such as I imagine the Access increment. I would
7 expect BT to have a more detailed understanding of exactly which services are the primary
8 ones sharing these common costs. In terms of the theory, the logic of combinatorial tests,
9 those are plainly the important tests to do. However, applying those combinatorial tests
10 runs into a number of difficulties. These are two of the difficulties that one would run into.
11 It is because the common costs in this particular case are shared across different increments,
12 it raises problems about potentially aggregated combinatorial tests being the relevant and
13 indeed the important ones, and yet one may be able to infer relatively little from them
14 because of other problems such as the service identification question, the rate of return
15 regulation and other points that were made in the Final Determination, such as
16 combinatorial tests that span charge controls and non-charge control services and that span
17 SMP and competitive services. So that is precisely an articulation of the problems, the
18 significant problems, involving using combinatorial tests to assess overcharging in this case.

19 Q What you are effectively saying is that combinatorial testing could never work in this
20 particular area because the common costs are just too widely spread.

21 A No, I'm not saying that. What I'm saying is that one would need to identify ways to address
22 these concerns.

23 Q The theory does address it, does it not, and can I ask you to take out bundle DF3 again. Can
24 I ask you to go to tab 3, which is an article. You agree that Mr. Baumol is effectively the
25 author of the theory of contestable market theory?

26 A He is one of the proponents, one of the originators of the theory of contestability, yes.

27 Q So this is an article written by one of the originators of the theory. If we look at p.80, he
28 specifically deals with this issue, does he not:

29 "As we noted earlier, full execution of the combinatorial requirement of the stand-
30 alone cost ceiling can be a mind-boggling task that threatens to make the entire
31 procedure impractical. This is not the place to describe the shortcuts and
32 approximations that have been devised to make it easier to calculate stand-alone
33 costs. But experience in railroad regulation has shown that such calculations are

1 feasible, and the determination of such cost figures has been a fairly routine
2 activity, with firms specializing in the requisite calculations.
3 In practice, there are straightforward ways to reduce the complications of the
4 combinatorial test problem in litigation and regulatory proceedings. First, the
5 firm's services can be aggregated into a smaller number of sets, each set composed
6 perhaps of a group of products sharing common facilities. If the company's
7 products are grouped into five to ten broad product lines, the task of calculating
8 stand-alone costs for each combination of these products is not overwhelming.
9 This shortcut is helpful even though it is sometimes necessary to carry the
10 disaggregation somewhat further. A customer complaining about high prices, for
11 example, may admit that the revenues of none of the aggregate groups or group
12 combinations exceed the corresponding stand-alone cost ceiling, but can charge
13 that the ceiling rule nonetheless is violated for a smaller subgroup. In such a case,
14 rather than requiring the regulated firm to perform the daunting task of calculating
15 stand-alone cost ceilings for every product combination's revenues any time a
16 change in prices is proposed, the complaining parties can (and should) be asked to
17 identify the particular product combinations for which they believe the ceiling is
18 violated. This exercise is equivalent to the potential entrants selecting the
19 combination of products that appears to promise the greatest profits. The
20 complaining party must be discouraged from arbitrarily proliferating the list of
21 suspect product combinations. Regulators can accomplish this by requiring the
22 complainant to proffer some preliminary evidence supporting its accusation.
23 The regulated firm can then be required in turn to provide the regulator with stand-
24 alone cost figures for the combinations of products whose prices require further
25 examination.”

26 So there is the author of contestable market theory saying in terms that large numbers
27 should not be a problem?

28 A Yes, and I addressed this point in my witness statement, if we look at my witness statement.
29 It is p.553 in core bundle 2, para.227. Paragraph 227 is, in fact, I believe this very quotation
30 that refers to this very passage in this paper that you have just read out. Then I address both
31 of the points about ways to reduce the complications of the combinatorial test problem by
32 aggregating the firm's services. As you will see from para.228, the point that I make there,
33 and it seems to me that it is absolutely the point that is being made by Baumol, Baumol says
34 that the firm's services can be aggregated into a smaller number of sets, each set composed

1 perhaps of a group of products sharing common facilities. It seems to me clear that the way
2 to derive the smaller number of sets would be to look at the services, the group of products,
3 that share the most common facilities. As we have seen from BT's analysis of the stand
4 alone costs and the source of common costs, terminating and trunk segments actually only
5 share a relatively small proportion of common costs and indeed other trunk segments, other
6 bandwidths, appear to only share a small proportion of the common costs. If I might refer
7 you, since it's so relevant, to that part of the determination ----

8 Q Do you want a confidential table – is that what you are referring to?

9 A Yes, it's p.928, table 7.6. 7.7 is, I think, the most useful table. We can see from this table –
10 do you have it – the intra-core common costs – I won't read out the figures because they are
11 confidential – but you can see the percentage of the stand alone costs of 2Mbit/s that is
12 accounted for by intra-core common costs, which is common costs which include common
13 costs shared amongst different trunk services, and common costs shared between trunk and
14 terminating services. The intra-network common cost, which is common cost shared
15 between different increments within the network, of which access and core are important
16 costs ----

17 Q Mr. Myers, I do not want to stop you, but I am slightly nervous about giving relative weight
18 to different percentages. I think you are making the point, and the Tribunal will no doubt
19 have that in mind, but I am just mindful ----

20 A The point was made in the determination that it is clear that the common costs, the most
21 important common costs, in this particular case for 2Mbit/s trunk, relates to common costs
22 shared with other network increments, such as Access. Therefore, that's the important way
23 – that's the way one should derive the smaller set, if there is a smaller set and I think one
24 can always derive a smaller set of important combinatorial tests, that is the way that should
25 be the guiding principle consistent with what Professor Baumol is saying. That is the way
26 one should derive the smaller set of combinatorial tests, and that of course does not include
27 any of the tests that BT conducted. On the second point of the quotation, which was
28 relating to asking the complaining party to identify the combinations to be tested, I will not
29 read it out, but my witness statement also addresses that point.

30 Q Sorry, which part of your witness statement are you referring to?

31 A The paragraphs I just referred to, para.227 on p.553 down to 230 on p.554.

32 Q It comes back to the basic point, does it not, that you need to have someone tell you what
33 they say are the most relevant tests?

1 A No, I'm sorry, I just do not agree. BT is the one that conducted the analysis of the stand
2 alone cost of 2Mbit/s trunk. BT was the one that had the information relating to where the
3 common costs arose, the extent to which they were intra-core common costs or intra-
4 network common costs. It should have been obvious to BT that the most important
5 combinatorial tests relate to the services that shared the largest proportion of common costs.

6 Q Mr. Myers, we have already seen BT asking Ofcom what tests, it will do further tests if
7 required. We have seen it provide another test, the Core test. We see, again if you go to
8 volume BT3, 11.1, BT saying in terms again, "What tests do you want us to do?" Ofcom
9 never specified them, did they?

10 A Ofcom identifies that it was important to look at where the common costs were shared, and
11 it was BT – I can't recall the precise extent and passage through Ofcom's analysis of BT's
12 stand alone costs modelling that had been conducted at the date of these meetings and this
13 exchange of correspondence. – that had the detailed analysis of the common costs and
14 where they arose and should have understood the important services with which those
15 common costs were shared. The other point, as I've already said, that was set out in the
16 letter from Martin Hill that you took me to before, was that the number and selection of
17 combinatorial tests was merely one of the concerns. It was not the overriding concern, it
18 was not the only concern. There were a raft of further concerns which were ultimately
19 summarised in para.5.56 in the determination, which included conceptual points about
20 service identification, about services spanning charge controls or non-control services and
21 competitive and SMP services, rate of return regulation. These are all concerns, and these
22 were the reasons why Ofcom took the view based on those concerns, unless a way to
23 address those concerns was identified, which at that point BT had not identified them, and
24 as I've discussed in my witness statement it's not always straightforward to identify how
25 one might address them, although I don't exclude the possibility that one could. Given that
26 range of concerns, that was the reason why Ofcom considered that further combinatorial
27 testing might not be very informative.

28 Q Look at file BT3, tab 11.1. This is the letter from BT of 7th August 2009. If you go to the
29 fifth page at para.16 they make the specific point that reported DSACs are derived from just
30 one combinatorial, yes?

31 A Yes.

32 Q That is true, is it not?

33 A Excuse me? Yes, the DSACs are derived from the stand alone costs of the core increment.

34 Q Then it says:

1 “However, this may not be the most relevant combination for the purposes of the
2 current dispute which is only concerned with the subset of the Core. We therefore
3 chose what we believed to be the reasonable combinations in the context of the
4 dispute and PPC charging. We also undertook to conduct further combinatorials
5 as required by you.”
6

7 If we go to the end of that letter at p.9 of 9 (I think this may be confidential). I do not want
8 to discuss anything to do with the figures, but you can see there they are providing the core
9 combinatorial as Mr. Budd said they were asked at the meeting on 1st July with Ofcom, yes?

10 A Yes, I see that.

11 Q Why, at this stage, did not someone at Ofcom turn round to BT and say: actually, we
12 happen to think that the most important set of services if the largest relevant
13 combinatorials?

14 A Because the reply in the next tab, which we’ve already discussed, sets out Ofcom’s position
15 at that time.

16 Q Sorry, the reply at the next tab?

17 A This is the letter from Martin Hill to Theresa Brown of 15th July.

18 Q Yes, so in other words, this letter we are now looking at is actually replying to it. I
19 apologise.

20 A So this was a reply to an earlier letter from BT. As you have already read out, this letter
21 says that there are a number of practical, conceptual and methodological concerns. That is
22 near the end of the second paragraph. “Most importantly, we very much doubt that we feel
23 BT to address these concerns” and these concerns include, but are not limited to, the
24 number and selection of combinations. So telling BT the combinatorial tests to do “such as
25 ones that are more aggregated across different increments” would have run into the
26 conceptual concerns that had been identified in the letter, and in which I understand there is
27 a degree of common ground that these aggregated combinatorial tests are relatively
28 uninformative. They run into the problem of service identification. It is unclear which
29 service is being overcharged, and they run into the problems such as rate of return
30 regulation. Therefore, since those further tests would not be very informative because of
31 these conceptual methodological concerns, I think that probably explains why Ofcom did
32 not go further in the suggestion BT undertake further work without those conceptual
33 concerns having already been addressed. Otherwise, it would have led BT to do work
34 which would not have led to anything terribly useful.

1 Q It never gave BT the opportunity.

2 A This letter gives BT the opportunity to see Ofcom's thinking, Ofcom's articulation of
3 concerns, and to undertake any further analysis that it considered relevant.

4 Q There is just one last question I want to ask before we have the short adjournment. That is
5 this. If you go to 11.3 in the bundle, this is a letter that unfortunately I have not put in
6 completely in sequence. This is the letter that BT sends to Mr. Hill on 13th July which leads
7 to the response of 15th July, which is the letter you have just been referring to and which in
8 turn leads to the response of 7th August which is at tab 11.1. Just for completeness, we see
9 again at the end of that letter:

10
11 "Next steps. We would be happy to provide any further information and/or
12 explanations required and carry out any other combinatorial tests that Ofcom
13 considers appropriate."

14
15 So again that is BT, is it not, asking Ofcom to tell them what tests they want.

16

17 A I have already explained why Ofcom considered that further combinatorial tests would not
18 have been appropriate or informative: because of the conceptual concerns which go beyond
19 the number and selection of combinatorial tests such as service identification, rate of return
20 regulation, spanning price control/non price control services. I will not repeat them all.
21 They are articulated and summarised in para.5.56 in the Determination.

22 Q Sir, will that be a convenient moment?

23 THE CHAIRMAN: That will, Mr. Read. Thank you very much. Five minutes.

24 (Adjourned for a short time)

25 MR. READ: Mr. Myers, can we now just very briefly turn to international benchmarking. I am
26 sure you will be glad to know that I am not suggesting that international benchmarking can
27 in any way be conclusive. The question is can you completely disregard it? The first point
28 I want to put to you, to see if we can agree this, is there are numerous instances, are there
29 not, of international benchmarking being used as a method for acting as some form of
30 benchmark as to performance in the telecoms field?

31 A I am sorry, I didn't quite catch the last part of your question.

32 Q Can we agree that there are numerous instances of, in telecoms regulation, various bodies
33 including the European Regulators' Group, various other regulatory material, etc, numerous

1 instances where international benchmarking is used to tell the regulator something about the
2 pricing?

3 A Yes, it can be useful information.

4 Q You had the information contained in the Deloitte's report. It is fair to say in the Draft
5 Determination that Ofcom primarily looked at that material and looked at the caveats to that
6 material and said; therefore it is not useful.

7 A In the Draft Determination? You may be right. I would have to check.

8 Q Let us have a brief look at this, shall we. Shall we go to the Draft Determination in BT 1 at
9 tab 4 p.27 para.3.36:

10
11 "Deloitte itself seems to acknowledge the difficulties in carrying out meaningful
12 benchmarking analysis of PPCs in the 'Methodology' section of its report. It is
13 noted that the 'structure of the PPCs and tariffs differ widely across the
14 benchmark sample making it difficult to make an exact like-for-like comparison
15 across a wide range of countries.' Deloitte went on to add that: 'Prices across
16 countries may differ for a number of reasons, including but not limited to different
17 geographies and effectiveness of regulation.'"

18
19 A Yes, I see that.

20 Q That is not actually the way that Deloitte itself was quite putting the matter, is it? Do not
21 put BT1 away. Can I ask you at this stage to turn to BT3 tab 10.1. This contains the
22 Deloitte's report. Look at para.48 and we see what Deloitte actually said:

23
24 "The structure of PPCs and tariffs differ widely across the benchmark sample
25 making it difficult to make and exact like-for-like comparison across a wide range
26 of countries. [That is part of what has been quoted in para.3.36.] However, by
27 developing service description parameters useful benchmarks can be made to
28 enable yardstick comparisons of prices on offer. Prices across countries may
29 differ for a number of reasons, including but not limited to different geographies
30 and effectiveness of regulation."

31
32 So that last sentence is also what is quoted in para.3.36, but it rather misses the fundamental
33 that Deloitte is making: "However, by developing service description parameters useful
34 benchmarks can be made to enable yardstick comparisons of prices on offer". So can we

1 agree to differ like this: that really it is a question of how you look at this international
2 benchmarking data, whether you look heavily at the caveats, or whether you look at the
3 material having some (maybe not conclusive) information that is useful?

4 A I think it's a question of the quality of the information. I mean, you've focused on what
5 Deloitte said in their report and how it was characterised in the Draft Determination. If we
6 look at the following paragraphs in the Draft Determination, particularly 3.39 onwards, we
7 can see that (I can't recall the extent to which this is prominent in the Deloitte's report) but
8 there's a bit of an absence of information for a number of companies on trunk segment
9 pricing, and since I think by this point of the investigation that was the fundamental purpose
10 to which it would have been put was to assess the reasonableness of trunk segment pricing,
11 and clearly that is a significant weakness for a number of countries in the study we do not
12 have reliable information on trunk segments itself, and that clearly affects the quality of the
13 information and therefore the weight that should be placed on it.

14 Q The point you are making in 3.37 is the fact there is only a cost orientation obligation in
15 respect of four of the countries – that is the point that is being made in 3.37?

16 A Sorry, I was referring to 3.39, 3.40, 3.41 ----

17 Q Well you started I think by referring to 3.37, although I accept you did go on to say other
18 things as well, but just concentrating on 3.37, you are not, for example, saying that you can
19 ignore any information about the other countries simply because there is no imposed cost
20 orientation obligation?

21 A No, it affects the quality of the information, this is a point that I made in my witness
22 statement, that where there was no cost orientation obligation applied, I think there were
23 two countries where that was the case – it was slightly fiddly, so I would actually prefer to
24 refer to my witness statement to make sure I get the details correct. This is on p.563,
25 starting at para.270 and in that paragraph under (a) and (b) I set out the countries where
26 there was an absence of cost orientation obligation and the implications of that, and in (b)
27 where there are trunk services subject to some regulation but no cost orientation obligation.
28 Then the inference is drawn in (c) because for these six countries we do not have trunk
29 prices at all. For a further two, as I recall we have a headline trunk price, but that price is
30 subject to discounting and in practice in such markets there can be a large difference in
31 general between the headline price and the discounted price, so there is a risk in those
32 further two countries that that price would not be very informative or representative of the
33 average price actually charged. Therefore, of the I think it was nine countries which

1 compared to the UK there were significant issues about the quality of the information on
2 trunk pricing for six of those countries.

3 Q Did Ofcom ask any of the other regulators for any more information about pricing in these
4 markets in the course of the determination?

5 A Not that I recall. I am not sure the regulators would know, it would be the regulators ----

6 Q The question was never asked?

7 A I don't know for sure – yes, perhaps I should stop at that; I don't know for sure whether
8 Ofcom did or did not.

9 Q Can I ask you to look at the final determination of that second core bundle. Can I ask you
10 to look at tab 31, para. 7.150, which is on p.932. This really sums up Ofcom's approach
11 does it not?

12 “The fundamental point, however, is that faced with actual cost data that indicates that BT
13 has overcharged for 2Mbit/s trunk services ...”

14 That is what you mean by “failed the DSAC test”, and that is the actual cost data?

15 A No, the cost data would also include the allocated costs and, indeed ----

16 Q Sorry?

17 A The fully allocated costs and the rate of return, which uses fully allocated costs and indeed
18 the cost data would also include the stand alone cost and the combinatorial cost, that is all
19 cost data.

20 Q Just pause there, and read it. “... is that faced with actual cost data that indicates that BT
21 has overcharged for 2Mbit/s trunk services”, so that is one item; “... and financial data that
22 shows that BT has earned very high rates of return on these services”?

23 A Yes I accept what you are saying. It appears that that first bit is referring to DSAC, and the
24 second bit to the rates of return relative to fully allocated costs.

25 Q So we are back to the same point, are we not, that in weighing up the international
26 benchmarking data, Ofcom has started from the presumption that prices in excess of DSAC
27 indicate that BT has overcharged. That is what that is saying?

28 A What that is saying is that that evidence suggests overcharging, indicates overcharging, and
29 one needs to look at evidence that might suggest the contrary, to weigh up the quality of that
30 information and how much weight can be placed upon it, and I think this paragraph needs to
31 be read in the context of the preceding paragraphs which explain some of the deficiencies in
32 the international benchmarking data, quite serious deficiencies, particularly in the case of
33 trunk segment pricing which go to the question of how much weight one can reasonably
34 place on that evidence.

1 Q But you would not disagree that para.7.150 is the approach that Ofcom has taken in this
2 case to the international benchmarking data, because that is what it says there?

3 A That is one point, yes. That is not the entirety of Ofcom’s analysis of the international
4 benchmarking data.

5 Q But it says it is “the fundamental point”, does it not? It does not say it is one point, it says:
6 “The fundamental point”?

7 A And that fundamental point needs to be seen in the context of the weaknesses and the
8 deficiencies in the pricing data as regards trunk segment prices in other countries.

9 Q Now, I want to move on to the question of economic harm, and I want to see if we can take
10 this quite quickly because you talked on Friday about your consideration of economic harm
11 being based on a counterfactual?

12 A Yes.

13 Q And I want to be quite clear that there is no difference between what you are saying and the
14 way the case was opened for Ofcom, so I am going to take you just to a single page, hand
15 up just a single page of the transcript – full versions are obviously available, and for your
16 reference, sir, it is transcript day 2, p.29.

17 A Do I have this?

18 Q (Document handed to witness) Now you have the full transcript. If one goes to p.29 of that
19 transcript. If I can just pick up, this is Mr. Saini opening the case for Ofcom, he says:
20 “It is said against us by Mr. Read, and indeed by Professor Yarrow and Dr.
21 Decker, that all of these sources of harm proceed on the assumption that pricing
22 above DSAC is excessive pricing. It was put yesterday as one of those cases
23 where one is assuming what one needs to prove.
24 But if DSAC is a first order test, then failing DSAC must have a consequence.
25 Failing DSAC gives rise to, at the very least, a presumption that there has been an
26 over-recovery of common costs. It has to be given some weight. If it is given no
27 weight then it is not a first order test, it is not any test at all.”

28 Do you see that?

29 A Yes.

30 Q And that is what, in essence, your counterfactual is doing, is it not?

31 A The point I made on Friday was that DSAC being the effective first order test would be a
32 counterfactual that it would be relevant to look at. But then one might also look at or
33 consider alternative counterfactuals.

1 Q The whole approach of Ofcom to this dispute determination is that failing DSAC has a
2 consequence, and it gives rise to a presumption that there has been an over recovery of
3 common costs - yes?

4 A The way I would put it is that it is an effective first order test for the likelihood of anti-
5 competitive or exploitative charging, that is what the guidelines say. So yes, and, the way I
6 believe I put it in my witness statement, that economic harm would normally follow. That
7 would be my position on the question.

8 Q So in other words you now accept, if you did not yesterday, that when Ofcom came to
9 consider economic harm in the final determination it did so on the basis that it was
10 presuming there had been an over recovery of common costs?

11 A No, I do not accept that. The section in the determination identifies that DSAC is a
12 counterfactual that Ofcom initially used in order to assess the financial impact of
13 overcharging and its impacts on retail demand. Then Ofcom considered, later in this
14 section, these paragraphs, alternative counterfactuals that had been put forward by BT and
15 so consideration is given to those alternative counterfactuals before concluding that they are
16 not relevant and not appropriate counterfactuals.

17 Q Can we just look at the final determination at p.908 again, para.7.36 in core bundle 2 at tab
18 31?

19 A Yes.

20 Q Let us look at what para. 7.36 says:

21 “BT’s 2Mbit/s trunk charges have resulted in the Disputing CPs and/or their retail
22 customers paying BT too much for these services, and therefore generating
23 financial loss or harm to them.”

24 Yes?

25 A This is a summary of Ofcom’s conclusion, this paragraph.

26 Q Let us start with 7.34:

27 “We accept the arguments of the Disputing CPs that economic harm is not a pre-
28 requisite to Ofcom’s determination of the Disputes.”

29 So in other words you are dismissing the need to investigate economic harm in any real
30 depth because it is not a pre-requisite to the determination of disputes?

31 A I have set out my position on this question in my witness statement, where I said that in a
32 sound economic analysis I would expect plausible serious harm to be identified to assess
33 whether there was a risk of those series of harm being relevant and to consider evidence to
34 suggest that harm would not arise. That is my position on that question.

1 Q Paragraph 7.34: “It is sufficient to establish that the overcharging could potentially cause
2 economic harm”?

3 A That is Ofcom’s position as set out in this determination, yes.

4 Q Then you go on to discuss what the financial impacts of overcharging might be, and that is
5 what we see from the heading above para. 7.38. So it is, is it not, exactly as Mr. Saini, in
6 our respectful submission, correctly summarised Ofcom’s approach on this, that failing
7 DSAC has a consequence and it gives rise to a presumption?

8 A I can restate my position on this which is that economic harm would normally follow, that is
9 what I said in my witness statement, from the failure of DSAC and that therefore that
10 implies it is an appropriate counterfactual to look at in many cases. There may be some
11 specific cases where an alternative counterfactual would be more appropriate and, as I said,
12 the determination went on to consider alternative counterfactuals.

13 Q Can I just ask you to look at your witness statement at para. 139, p 528, tab 2 of core bundle
14 2? You are discussing there some of the various material that pre-dates the 1997
15 Guidelines. If you go over the page to 529, you see you actually quote some of the
16 material, including:

17 “If a charge was set above the floor, the burden of proof would lie with a
18 complainant to show that the charge could be expected to be anti-competitive. If a
19 charge was set below the charge floor, the burden of proof would lie with BT to
20 demonstrate that the charge was not anti-competitive..”

21 Then you quote another document in para.140, and that says in terms:

22 “If a charge were set above the floor, the burden of proof would lie with the
23 complainant to show that the charges could be expected to be anti-competitive,
24 unduly discriminatory or unfair. If it wished to set a charge which were below the
25 floor, the burden of proof would like with BT to demonstrate that the charge would
26 not have these effects.”

27 So back pre-dating the 1997 Guidelines there was specific consideration of whether a
28 burden of proof should actually be imposed on anyone and how it should be imposed – yes?

29 A That’s correct.

30 Q And none of this burden of proof appears in the 1997 Guidelines themselves?

31 A That’s correct.

32 Q So the fact that Ofcom now uses DSAC to create a burden of proof runs contrary to the
33 express consideration that was taking place well before the 1997 Guidelines?

1 A I think I can only comment on the guidelines and the economic analysis. I understand that
2 has been changed in the legal provisions, which obviously I'm not in a position ----

3 Q Perhaps that is an unfair question to have asked you. It is also right to say that Ofcom takes
4 the view that when you are carrying out an investigation into dispute determination, you do
5 not have to give it any real importance in the hierarchy of things because you carried out
6 that exercise in 2004 in imposing the ----

7 A That's a point of context, and I'm not sure I necessarily agree with your characterisation of
8 the implication.

9 Q Just so we are clear about it, perhaps I could ask you to take core bundle 1 and ask you to
10 look at tab 7, which is Ofcom's defence in this case, and ask you to go to p.177, para.128.
11 You can see that it has been put:

12 "… BT's argument is inconsistent with the Act and the Access Directive."
13 It sets out what the Access Directives are. Then it says:

14 "The Act and the Access Directive do not prescribe any further mandatory
15 requirements about economic effects that have to be satisfied before a regulator
16 can conclude that there has been a breach of a cost orientation condition imposition
17 in accordance with the Act and the Access Directive."
18 Yes?

19 A I see it says that, yes.

20 Q Do you accept that when Ofcom came to consider the issue of whether there was
21 competitive harm or not, part of the process it went through was the fact that it had already
22 investigated all the effects of competition and effect on consumers back in 2004?

23 A As I said on Friday, that's an important point of context, yes.

24 Q The final point I want to put to you is that the effects of those two contexts, presumptions,
25 call them what you will, is that Ofcom did not carry out any detailed inquiry into
26 competitive effects, an investigation of the market and the effect on consumers. You
27 gauged it all by reference to whether there was overcharge, whether, if there was
28 overcharging, as the DSAC past test illustrated, whether there would be, or could be, the
29 potential for any economic harm?

30 A No, I don't agree with that characterisation. The analysis of economic harm in the
31 determination is set out from paras.7.32 to 7.72, I think, and I think that accords with the
32 way you have just characterised it.

1 Q I think that is probably a matter for submission rather than for cross-examination. Can I
2 briefly turn to the issue of aggregation and disaggregation. You accept that the obligation
3 talks about costs that are reasonably derived with an appropriate mark-up – yes?

4 A Yes.

5 Q The question I want to ask is, how can you really gauge those without also looking at how
6 the product is actually sold? How can you work out what has been reasonably derived and
7 what constitutes an appropriate mark-up if you do not do it by looking at what is actually
8 being bought by people?

9 A Could you just clarify what you mean by “actually being bought”?

10 Q I am talking about the circuits being bought.

11 A So economically and in terms of the regulatory analysis, what is happening in a case where
12 both terminating and trunk segments are being bought if there’s more than one wholesale
13 service that is being purchased by a CP from BT, purchasing a trunk service and purchasing
14 a terminating service. That’s the appropriate approach from an economic and regulatory
15 perspective because the terminating segment can be bought with or without the trunk
16 segment. Therefore, there’s a choice to be made about whether two services are purchased
17 from BT or just the one, the terminating segment. Therefore, if the analysis is about trunk
18 services, that is an economically meaningful price and it is appropriate to look at that price
19 without aggregating it with terminating segments. One would need to look at the
20 appropriate sharing of common costs, what would constitute a reasonable proportion of
21 common costs, but as we’ve already seen there’s relatively little compared to other services,
22 common costs shared between trunk and terminating segments compared to those shared
23 between trunk and other services in other increments.

24 Q How can you gauge what is meant by “economically meaningful” whatever the phrase
25 actually is without actually looking at the whole of the way the material is being sold?

26 A The way the circuits are being sold is CPs are making choices about whether or not to
27 purchase trunk segments from BT. Where they do, they typically, or perhaps always,
28 purchase it with a terminating segment, but they have a choice, and they exercise that
29 choice not to purchase trunk but to either self-supply it or purchase it from other CPs, even
30 where they are buying the terminating segment from BT. That is, therefore, an
31 economically meaningful price signal because it affects CPs’ choices, it affects their
32 position in the downstream market, you would expect it to affect downstream prices, and
33 indeed their investment decisions in the wholesale trunk market.

1 Q You did not actually have any material, did you, when this was all being put before you as
2 to actual pricing decisions that were being taken, or anything like that, you simply had the
3 suggestion that because trunk might be sold in different proportions, that therefore led to the
4 potential for economic ----

5 A It's a fundamental economic point that trunk is purchased is different proportions, and there
6 was evidence on that looking at the relative proportions of trunk and terminating segments
7 purchased by different CPs, which was certainly relevant to a number of issues, including
8 the question of economic harm. So that was evidence that was used.

9 Q Can I just see if there is any common ground between us. You accept that trunk is never
10 sold without a terminating segment, do you not?

11 A I do.

12 Q You also accept that there is no clear cut answer to cost allocation?

13 A Could you just elaborate what you mean by "no clear cut answer to cost allocation"?

14 Q Let me take you to the final determination. If you go to p.1006 in the second core bundle,
15 tab 31, and go to annex 11, which is dealing with the economics of cost orientation, we see
16 in terms at A11.6:

17 "Because of the existence of significant common costs between BT's activities, BT
18 will only recover costs overall if at least some of its charges are above LRIC.

19 However, there may be many different ways of attributing these common costs to
20 different services, none of which may be uniquely correct or uniquely reasonable."

21 A Yes, I absolutely agree with that.

22 Q Because you accepted earlier on that this is the section that you had quite a big input into?

23 A This is a fundamental economic point. It's well understood and I agree with it.

24 Q So understanding exactly how interlinked trunk and terminating are is pretty important to
25 any economic assessment of what is going on?

26 A No, that's not correct, that doesn't follow. One could consider the relationship between
27 trunk and terminating segments either on the costs side or on the demand side. On the costs
28 side there is a degree of sharing of common costs, and to that extent it would be relevant to
29 consider that in the context of considering the price of trunk services relative to the cost of
30 trunk, to consider the sharing of common costs between trunk and terminating segments,
31 but at the risk of repeating myself, that sharing of common costs is actually relatively
32 unimportant compared to the sharing of common costs between trunk and other services.
33 So the cost side, the question of allocation of common costs, does not suggest any particular
34 primacy to be given to considering terminating segments alongside trunk segments, and in

1 either case it does not suggest necessarily just simply aggregating them and looking at
2 aggregated rates of return, which is a further step. On the demand side, the question is,
3 fundamentally, whether the trunk price is economically meaningful. When I say “on the
4 demand side”, I mean from the point of view of CPs, their demand for trunk segments. Is
5 the trunk price a meaningful price from the point of view of the demand side or can it only
6 be considered meaningful when looked at together with the terminating segment prices. I
7 would say that clearly the trunk is economically meaningful on its own. There are decisions
8 and judgments being made which are influenced by that trunk price. Even if other prices
9 would also come into those judgments the trunk price plays a distinct role in those
10 economic decisions in relation to downstream pricing, downstream competition and
11 investment decisions in the trunk market. As to, if you like, the further possible point, the
12 trunk price is economic and meaningful, the terminating segments are economic and
13 meaningful on their own as well, but there clearly is a relationship in demand between trunk
14 and terminating segments. They have a degree of complementarity. First of all, it is worth
15 noting that that is not anything unique to trunk segments. I draw the analogy in my witness
16 statement with PSTN services, with voice interconnection services and local tandem
17 conveyance. That has been specified as a service whose price has been assessed relative to
18 its costs distinctly. The local tandem conveyance service is never purchased on its own. It
19 would be purchased in conjunction with either call origination or call termination, the so-
20 called the local exchange segment service. So this situation can easily arise, and does arise,
21 in a number of cases in terms of the range of wholesale services that are provided by BT.

22 Q Mr. Myers, that is a very long – sorry, had you finished?

23 A I hadn't quite completed my explanation. The economic theory would suggest that actually
24 welfare optimal prices should take account of those demand side inter-relationships, even if
25 it's looser than just meaning that there isn't a distinct economically meaningful price.
26 However, that would be a completely alternative regime for wholesale charges from the one
27 that has been put in place, not just in relation to PPCs, but in relation to other inter-
28 connection services. That regime sets prices for economically meaningful services relative
29 to cost – cost based prices, cost orientated prices, if you like – and then the demand side
30 interactions between those services is taken into account by the purchases. So two services
31 may be substitutes. In this case two services may be complements. Reasonably efficient
32 price signals are given to those purchases by setting each of those prices in a costs basis,
33 costs base relative to the costs of that individual service. So that is the way in which the
34 regime takes account of those demand side inter-relationships.

1 Q Are you saying that you never actually in any of this analysis considered how exactly
2 circuits were being sold?

3 A Well, yes, I did take account of how circuits were being sold, and circuits can be sold with
4 and without trunk segments.

5 Q Can I just ask you to look at annex 7 in the final determination at p.981. Do you see that?

6 A Yes.

7 Q Presumably this is the diagram upon which you based your view as to the nature of the
8 circuits?

9 A Not solely based on this diagram, it's based on the analysis in the market reviews. The fact
10 that a distinct market for wholesale trunk segments has been defined and market power have
11 been assessed in that market in both the 2004 and 2008 market reviews reflects the fact that
12 it is an economically meaningful service on its own.

13 Q That diagram suggests that the main link only applies in the terminating segment, does it
14 not?

15 A It only identifies main link under terminating segment, I agree.

16 Q Whereas we know from Mr. Morden's evidence, which has not been challenged, that, in
17 fact, the main link covers both the terminating segment and the trunk segment. If you
18 would like to take the authorities bundle – I do not know if that is there.

19 A I think I would accept the point, if that saves time.

20 Q Sorry?

21 A I accept the point that – sorry, the factual point. I do not accept the implication that BT
22 draws from that point.

23 Q Fundamentally, it has misunderstood how exactly the product operates, has it not?

24 A On the contrary, I think that is a failure to distinguish between the physical way in which
25 services may be routed or provided compared to the conceptual or logical way, and
26 logically there is a distinct set of trunk services which can be purchased or not purchased
27 from BT, and can be purchased along with terminating segments, or terminating segments
28 can be purchased without trunk. As I say, that is fundamental. That is, if you like, the
29 market definitions in the market reviews in both 2004 and 2008 reflect that underlying
30 point. If it wasn't an economically meaningful service, trunk segments, I wouldn't expect
31 there to be a distinct market for it. One is the flip side of the other.

32 Q Mr. Myers, can you actually turn to the Authorities bundle. Can you find it? It is Authority
33 bundle 2, it should be AUT 2. Go to tab 53, this is the agreed Glossary of the PPC and if

1 you go to the third page of that you see the point that is being made there is the SDH
2 transmission takes part throughout the whole of the main link, does it not?

3 A Yes.

4 Q If you look down the bottom there it has got “Main link fixed charge, Terminating per
5 kilometre charge, Trunk per kilometre charge”, does it not?

6 A Yes.

7 Q Bang in the centre of it is the SDH transmission. Surely, if you are going to consider
8 whether or not something is likely or not likely to cause economic harm you need to
9 understand the precise relationship between the component parts of what you are looking
10 at?

11 A My previous answer is how I would answer this question as well, which is looking at the
12 physical relationship for facilities used does not determine the economic nature of the
13 service. That is determined based on an economic analysis. My understanding of the
14 argument you’re putting to me is that an implication of that argument is that the market
15 definition is there should not be a separate market for trunk segments. The trunk and
16 terminating segments markets should be one and the same. That seemed to me to be a
17 logical implication of the argument you’re putting to me, with the implication that you’re
18 drawing. As I say, there’s a distinction between the physical routing, the nature of the
19 services, the nature of the components that are being used, and logically, the nature of
20 service from the point of view of a purchaser in the value chain. On that basis, on that
21 economic basis, there’s a distinction between trunk and terminating segments, even if there
22 is sharing of network facilities. Again, that is an extremely common point. There are many
23 distinct wholesale services which share use of the same network facilities. There’s nothing
24 unique here about terminating and trunk segments.

25 Q Is not the position this: that the more granular the focus the greater the potential for
26 anomalies caused by the precise allocation of costs between those granular entities?

27 A As a general point, yes, there is some question there about reliability of more granular
28 information which would need to be considered alongside the relevance of that information.
29 In my view, the relevance question, the relevance criteria, clearly points to looking at trunk
30 on its own.

31 Q It is a point that has been made in the Regulatory Financial Statements on various
32 occasions, has it not, that in fact the more granular the focus the greater the problems of
33 there being some anomaly in the cost allocation?

1 A We've seen, from the way in which BT's accounts have evolved and Ofcom's analysis of
2 split of costs between trunk and terminating segments, that there are some issues about that
3 that Ofcom had in 2004, and again in the 2005 own initiative investigation. So yes,
4 Ofcom's analysis there and, for example, the actions flowing from the 2005 own initiative
5 were in order to improve the quality of the information for trunk segments looked at
6 distinctly by looking at the split of costs between trunk and terminating segments.

7 Q So in 2005 you say it was all very clear that there had to be a more granular focus, or what?

8 A Not more granular than there had been before. The analysis had always looked at trunk and
9 terminating segments. In terms of the services, starting from the economic viewpoint,
10 looking at those services on a distinct basis and the actual evidence used sometimes is
11 broader than that because the split, the more granular (as you put it) split of costs between
12 trunk and terminating segments was simply unreliable. So that was the case in 2004 when
13 setting the terminating segment price caps, for example.

14 Q You accept, do you, in 2004 when a new regulatory regime was being brought in -- let us
15 start by taking core bundle 1.

16 A Can I put some of these other bundles away?

17 Q Yes, by all means. Keep core bundle 2 open, but put away the transcript bundles, the
18 authority bundle and BT3 and BT1 if you still have them out. Put away everything apart
19 from core bundle 1 and core bundle 2. We will have a very brief look at core bundle 1 tab 6
20 p.117. I think we may have looked at this before. There we see how things are split in the
21 2003 RFS to 31st March 2004. Do you see that?

22 A Yes.

23 Q We see very clearly there that in fact PC rental 2 Mbit trunk was actually specified as a
24 specific category in itself, yes? You can see that from the two tables. I think it is about
25 seven down.

26 A I am sorry, I was not quite clear what you were asking me to look at.

27 Q Page 117. All I am taking you to to show this is that prior to the 2004 process BT was
28 splitting out the individual trunk segments. Do you see that? I was simply taking this as a
29 short cut.

30 A Yes, I see some information. I think it is over the page, is it?

31 Q It is on both pages. One page is the year end 31st March 2003 and the other is year end 31st
32 March 2004.

33 A Sorry, I see, yes.

1 Q The only point that I am taking you to in this is to demonstrate that at that time, in 2003 and
2 2004, Oftel and Ofcom were requiring BT to split out 2 Mbit trunk yes? I think it is self
3 evident.

4 A They are split out. I don't know whether they were required to or not, but they are split out.
5 I am not disputing. I am just saying factually I'm not certain whether these were cut out
6 from regulatory obligation or from some other process, but yes, clearly they are split out.

7 Q However, when we come to the 2005 Regulatory Financial Statements, which as a direct
8 result of the process by which Ofcom required BT to report, 2 Mbit was not split out; it was
9 a compendious of trunk segments together. Do you want to see that at all?

10 A If I may.

11 Q You need additional document bundle 3 tab 5 p.123. We see that the specification at this
12 stage (and if need be I can take you back in the document and show you that it is Ofcom
13 who are requiring it to be done) was for a whole trunk segment services as a whole; it was
14 not split down to 2 Mbit or any other form of trunk.

15 A It is trunk segments separately from terminating segments but not split by bandwidth?

16 Q Yes. So in other words, what Ofcom has done is they have actually said that as part of the
17 2004 process trunk segments do not have to be individually specified in the RFS.

18 A Are you asking me what Ofcom required?

19 Q I am putting to you it is obvious from this document, is it not?

20 A This is what BT published in that year. My understanding is in subsequent years the
21 information is published separately for different bandwidths.

22 Q Perhaps we can just look back a bit earlier in that document to p.16. We see the regulatory
23 framework:

24 "As part of this series of reviews, Oftel and Ofcom published a number of
25 consultation documents during 2003 and 2004 proposing changes to BT's regulatory
26 financial reporting to meet the new regulatory framework. This resulted in a final
27 statement and notification from Ofcom on 22 July 2004 ... as amended by the Final
28 Statement and Notification entitled 'Changes to BT's regulatory financial reporting
29 framework' issued by Ofcom on 31 August 2005 ... to implement the remedies
30 identified by the market reviews in a proportionate and appropriate manner. These
31 proposals are intended to take effect for the year ended 31 March 2005 Current Cost
32 Financial Statements and have been implemented by BT.

1 “The changes to BT’s regulatory financial reporting included the requirement to
2 produce a Regulatory Financial Review as set out in Annex 2 to Direction 3 of the
3 22 July 2004 final statement.”

4 What I am putting to you, Mr. Myers, is that these Regulatory Financial Statements were
5 prepared in accordance with what Ofcom was telling BT to do as part of the 2004 process,
6 is it not?

7 A I’m not sure I’m able to assist you in terms of the reasons why that was done in 2005
8 whereas in subsequent years the costs were shown distinct. I wasn’t sufficiently close to the
9 detail of the regulatory accounting obligations to understand precisely why that occurred in
10 2005.

11 Q I think the answer is, Mr. Myers, that because you obviously are not familiar with these
12 documents there is not much point in me cross-examining you on them. They can be
13 matters for submission subsequently.

14 MISS ROSE: Sir, in the interests of completeness on that point, can I suggest that it might be
15 appropriate to go to the accounts for the following year, 2006 at tab 6. In particular, you
16 can see an answer to the question that Mr. Read has put at pp.7 to 8 of that document where
17 there is a heading “Requirements for Regulatory Financial Reporting” which says:

18 “The regulatory financial reporting requirements set out in the Final Statements
19 and Notifications are imposed to facilitate the monitoring and enforcement of
20 obligations imposed on BT: to offer cost-orientated charges and not to
21 discriminate unduly.”

22 Then there is a list of wholesale markets including wholesale trunk segments. Then at p.8
23 in the second column it says:

24 “In respect of each where cost accounting obligations are imposed (see * in list
25 above) the Current Cost Financial Statements also include statements for
26 individual services (‘Wholesale Service Statements’). The Wholesale Service
27 Statements comprise separate statements of costs and charges for each of the
28 services within each Market set out in the following statements.”

29 As the Tribunal will recall, in this year each of the bandwidths for trunk was separately
30 dealt with in the accounts. Indeed, you can see that at p.135 of the same document. That
31 may be the answer to the question Mr. Read was asking that as from 2006 it was recognised
32 that it was necessary to have separate costs and charges for each of the services within the
33 regulated wholesale market of trunk.

1 MR. READ: Sir, there are a number of documents I could take the witness to, but the witness has
2 just said that he is not familiar with these documents, which is the very reason why I said I
3 will put that to one side. My learned friend has made one submission on the point; I will no
4 doubt in due course be making another.

5 THE CHAIRMAN: Yes, it is helpful to have the document referred to but I agree these are not
6 matters I think for Mr. Myers unless he feels he has something factual to say on these
7 points. It seems to me they are better left to submission.

8 MR. READ: Can I just conclude by putting this to you, Mr. Myers, that effectively the final
9 determination dismisses each of the following pieces of evidence. First, any piece of
10 evidence that looks at PPCs in aggregate - yes? You agree because that is a result of
11 Ofcom's approach, that they only look at the services disaggregated?

12 A For the purposes of setting overcharging that is correct.

13 Q So that means that the ROCE for all PPCs is dismissed when looking at the question of
14 overcharging?

15 A That is correct, yes.

16 Q It also means that the circuit analysis is dismissed, even though that is looking at the circuits
17 actually sold?

18 A Well I dispute the characterisation of circuits actually sold, because I've explained comprise
19 more than one wholesale service of terminating and trunk segments, but I agree that Ofcom
20 did not place weight on the circuit analysis for the purposes of assessing overcharging.

21 Q You dismiss combinatorial testing because, first, it was too difficult to do in the context of
22 dispute resolution, which is the point that was being made in the draft determination at
23 A13.13 - yes?

24 A Well the reasons why Ofcom disagreed and did not place sufficient weight to alter its
25 conclusions from the combinatorial test evidence provided by BT is set out in para. 5.56 in
26 the determination.

27 Q You also dismiss international benchmarking for the reasons that we have discussed earlier
28 on today?

29 A Well I perhaps would slightly take issue with the word "dismiss". Ofcom concluded,
30 having looked at the quality of that information, that it was not sufficiently relevant or
31 reliable to alter its conclusions.

32 Q You place no weight on the fact of the efficiency gains that BT has gone through this period
33 from 2004 to 2008, no emphasis is placed on that as a factor against overcharging?

1 A I am sorry, I am not quite clear how one would place – what is the point that one would
2 place weight on?

3 Q I am saying that in assessing whether there is overcharging you do not consider that the
4 efficiency gains have any relevance, let me put it like that?

5 A Well the efficiency gains will be reflected in the cost analysis considered, but I am not sure
6 if you are making a different point.

7 Q You also dismiss any primary focus on economic harm because you say, first, when it is
8 read in context that is not what the 1997 guidelines actually suggest?

9 A No, I disagree that the primary focus on harm is dismissed. As I said, the overarching
10 economic concern – I said this on Friday – the overarching economic concern is the adverse
11 effect on consumers and competition; that is the primary focus in that sense, in the sense in
12 which I understand it to be used in the guidelines, and Ofcom’s analysis was consistent with
13 that. It is just how one assesses consistency, how one conducts an investigation consistent
14 with that primary focus depends on the context.

15 Q And you apply “a presumption”, as Mr. Saini called it on Thursday of last week, against
16 which to consider the issue of economic harm, which we have been through today?

17 A We have been through and, as I said, it is a relevant counterfactual to look at but one would
18 also look at other counterfactuals to see whether they are relevant.

19 Q Because the point is this, is it not, Mr. Myers, that when you have stripped out all of that,
20 you effectively are left looking solely at whether BT has passed or failed the DSAC tests?

21 A No, I don’t agree with that. Ofcom’s conclusion reflected the first order tests, the analysis
22 of extent of duration of charges above DSAC for the 2Mbit/s trunk services. It also took
23 account of the rate of return evidence on trunk segments, which supported that implication
24 from the analysis of DSAC, and Ofcom’s analysis of economic harm. Ofcom concluded
25 that harm was likely to arise, and that also supported the conclusion of overcharging.

26 MR. READ: Yes, thank you, Mr. Myers, if you would just like to wait there you may be asked
27 some more questions.

28 MR. SAINI: I have no questions (...no microphone ...)

29 THE CHAIRMAN: Mr. Myers, thank you very much.

30 (The witness withdrew)

31 MISS ROSE: Sir, I believe the next witness is Mr. Harding. Can I suggest that the appropriate
32 way forward would be for us to break for lunch now and perhaps start at quarter to two with
33 Mr. Harding.

1 THE CHAIRMAN: That will give us a chance to clear the decks and be ready for the next
2 witness.

3 MISS ROSE: Yes, and one other matter, at least in my bundle the second witness statement of
4 Mr. Harding was an unsigned version and I have a signed version here which is identical to
5 the version that is in vol.2 of the core bundle, can I perhaps hand that up? (Document
6 handed)

7 THE CHAIRMAN: Yes, that will be helpful.

8 MISS ROSE: I do not know whether the other parties would like copies. It is identical, except
9 for the signature, but we can perhaps ask ----

10 MR. READ: I think it only comes about because more information has actually been included in
11 that statement that is not marked confidential, and so therefore whether it is signed or not it
12 is already elsewhere in the bundles in a signed format.

13 THE CHAIRMAN: Yes, having worked from the non-core bundles, I think I have seen them all
14 signed. We will say quarter to two. Thank you very much.
15 (Adjourned for a short time)
16

17 MISS ROSE: Sir, I call Mr. Harding.
18 Mr. NICHOLAS SCOTT HARDING, Sworn
19 Examined by Miss ROSE

20 Q Mr. Harding, you should have in front of you various bundles?
21 A Yes.
22 Q Can you take up core bundle 2, and turn to tab 19 in that bundle?
23 A Yes.
24 Q You are Nicholas Scott Harding?
25 A That's right.
26 Q And you see here a witness statement with your name on?
27 A Yes.
28 Q And if we go down to p.618, is that your signature?
29 A That is.
30 Q And is this your evidence?
31 A It is.
32 Q Can you then pick up vol. INT3? Sir, you can take it in the core bundle at tab 20, but I am
33 simply showing the signed version. (To the witness): Tab 1?
34 A Yes.

1 Q Again a statement with your name on it?
2 A Yes.
3 Q And do you have a signature at p.4?
4 A Yes.
5 Q And again, does that represent your evidence?
6 A It does.
7 Q If we just turn briefly back to your first witness statement, and go to paragraph 41 at p.599.
8 You say:
9 “There are a number of factors that go into the decision of whether to purchase a
10 PPC and if so specifically what will be purchased.”
11 Then at paras. 42 down to para. 48 you describe various options that may be open to a
12 communications provider in deciding whether to purchase a PPC, if so whether to purchase
13 it from BT and in relation to the route if you go to para. 47?
14 A Yes.
15 Q You say:
16 “... the total cost of the PPC will be determined by the location of the specific
17 Point of Handover that the CP orders the circuit from. Therefore the CP will
18 always seek to choose the Point of Handover that minimises the cost specifically
19 taking into account the distance of trunk and terminating segment they will have
20 to purchase.”
21 Can you give us an example of what this means in practice?
22 A Yes, and looking actually at para. 45 there are some options there, and that is probably a
23 good place to start, with reference to an example that I think was used on Friday about a
24 circuit from Weston-super-Mare to Bristol. I think the example given – I wasn’t in the
25 room at the time – was for a customer in Weston-super-Mare, a voice customer, and Cable
26 and Wireless ----
27 MR. READ: Sir, just before the witness gives his answer to this, I just want to put the marker
28 down of course that because none of this has been, if you like, adduced in evidence earlier
29 on as an illustration for these paragraphs, of course BT has no opportunity to comment on
30 the illustration that is being given.
31 THE CHAIRMAN: I understand.
32 MR. READ: I put that down, I am not trying to exclude the answer.
33 THE CHAIRMAN: It is an illustration only, so do continue with your answer.

1 A Yes, so from Cable and Wireless's perspective they have a switch in Bristol and they have
2 interconnects for Partial Private Circuits in both Bristol and Cardiff, but in this example
3 Cardiff is the tier 1 node for Weston-super-Mare. So if we look down at 45 really there are
4 three of these examples, which for Cable and Wireless are meaningful options, the others
5 might be more so for other CPs. First, if we just look at (d), normally we would look first
6 of all, had we got connectivity to that end user to our site, because obviously that is the best
7 option for us, but in the case of Weston-super-Mare it was highly unlikely that we would be
8 able to self-supply the whole circuit, so we come down to needing a PPC, and then really
9 options (a) and (b) are the two which the decision has to be made between. So first of all,
10 we could purchase the circuit entirely from BT, i.e. we want to get from Weston-super-
11 Mare to Bristol, so we could buy that as a PPC, but because Cardiff is the home Tier 1 node
12 the pricing would assume that the circuit had been routed via Cardiff, and so we would pay
13 some trunk and some terminating segment for that circuit. I think in that example roughly
14 two-thirds would be trunk and roughly one-third would be terminating segment.
15 Alternatively, we could do (b), because we have a handover in Cardiff itself, we could
16 actually use our own network to Cardiff and then buy the PPC from Cardiff down to
17 Weston-super-Mare. It would be a similar distance PPC, but we would avoid any use of
18 trunk because we had got to the right Tier 1 node. But of course what we have done there is
19 we have had to use some of our own network, and our own network has a cost associated
20 with it. It might already be there, in which case we do not need to spend any money apart
21 from just to configure the capacity on that particular moment, but of course that would bring
22 forth the time when we would have to spend money. It might be that there is not capacity
23 there in which case we would have to upgrade the capacity in order to make that choice, but
24 we have very much those two choices to make.

25 Q Going back to your witness statement at para. 48 you explain that you have:

26 "... a computer based tool that will estimate the cost and feasibility of a variety of
27 access methods for any given requirement and the planner or service designer will
28 use the output from that tool to select the best method for the specific
29 requirement."

30 When you are planning your circuits are you able to differentiate between the purchase of
31 terminating segments and trunk segments?

32 A Absolutely, yes. There are a couple of different tools that can be used. I believe BT has an
33 online tool which you can put in A and B ends and it will tell you what you will be buying
34 and what you will be paying for, an estimate. We use a tool that we have developed in-

1 house which relies on data from BT and that provides data on all of BT's nodes, the Tier 1
2 nodes, and the lower order nodes, and where individual customer premises which serve the
3 exchange out of MAP2 and hence which Tier 1 exchange, and using that information we
4 will put in the postcode of a particular customer we want to address and that will give us a
5 whole list of options. It will tell us whether we have our own fibre near that particular
6 customer site and estimate how much it might cost for us to dig that, but it would also tell us
7 the cost of routing a PPC either to the closest PPC handover we have got, or to other PPC
8 handovers, and in each case it will calculate the amount of terminating segment, and the
9 amount of trunk to provide the service designer with that cost estimate. Obviously the
10 actual cost is confirmed when the circuit is ordered from BT but we have a pretty accurate
11 idea of exactly what it is going to cost because of distances of trunk and terminating
12 segment it will contain.

13 Q In your case you have explained that you have your own computer based tool that does
14 that. Do you also receive data from BT that would enable you to differentiate between
15 terminating and trunk segments when you are putting together circuits?

16 A I believe the online tool that BT provides does differentiate between trunk and terminating
17 segment, and we do not particularly need to use it because we have our own tool, but I
18 believe that is the case.

19 Q Do you know how long BT has been providing that information for?

20 A I don't know exactly, but I know we've had our tool since – my first recollection of it I
21 think was 2006, we may well have had that beforehand, but we would certainly have had
22 the necessary information to make the underlying calculations before that, I am sure.

23 Q You have given us the example of Weston-super-Mare where the shortest distance is to
24 Bristol, but it is cheaper to go via Cardiff because of the terminating trunk situation. Is that
25 just a geographical quirk caused by the existence of the Bristol Channel, or is that
26 something that could be duplicated in other parts of the United Kingdom?

27 A In part, so it is true to say that the existence of that big body of water between the whole of
28 kind of North Devon/Cornwall and South Wales where that Tier 1 node is exaggerates the
29 issue, but you see the issue throughout the country really. It is wherever you have two Tier
30 1 nodes but you want to connect to a customer who is roughly equidistant between the two
31 Tier 1 nodes. Another example would be a customer in Hinckley. Hinckley is roughly half
32 way between Leicester and Coventry – Leicester to the North, Coventry to the South –
33 Coventry is a Tier 1 node serving Hinckley, so if a CP wants to avoid trunk they need to
34 connect to Coventry. If they connect the circuit back through Leicester then they will pay

1 an element of trunk charge within the price of the PPC. But obviously, if the ultimate
2 destination of that circuit is Leicester, or anywhere North, then what that does is, it requires
3 them to use their own network to go not just to Leicester, but actually to go all the way
4 further south to Coventry and then get BT to route them back up again. So it is the same
5 kind of example really where the choices are very much influenced by the price of trunk and
6 a signal which is saying to the CP ordering the circuit that they are much better off if they
7 can avoid that trunk but they avoid it at a cost to themselves.

8 MISS ROSE: I have no further questions, if you will wait there, please.

9 THE CHAIRMAN: Mr. Saini, do you have any questions?

10 MR. SAINI: I have no questions.

11 Cross-examined by Mr. READ

12 Q I am obviously not going to cross-examine on that material; it is all new and none of our
13 witnesses have had a chance of dealing with it.

14 MISS ROSE: Can I also put down a marker which is that that is not new, that example was put to
15 the BT witness on Friday, and I therefore do not accept that there has been no opportunity
16 for Mr. Read to take instructions on that example over the weekend and to cross-examine on
17 it.

18 THE CHAIRMAN: Both your markers are in mind, thank you.

19 MR. READ: Mr. Harding, it is fair to say that you have had a heavy involvement in the
20 presentation of the disputing CPs' case throughout the process of this dispute resolution
21 process?

22 A It is, yes.

23 Q If, perhaps we just take vol. BT1, and if we look at tab 6, which is towards the end of that
24 bundle. If we look at the first page, enumerated "1" at the bottom, so it is in fact three
25 pages in, we see from paras. 1.1 and 1.2 that in fact the primary proponents of putting the
26 dispute forward are "THUS" and Cable and Wireless, do you see that?

27 A Yes.

28 Q In fact, we now know that they are actually the same entity, but then they were different
29 entities. The dispute submission specifically has, I think on p.4, your details for Cable and
30 Wireless?

31 A It does, yes.

32 Q So this was a document that you were intimately involved in in putting together?

33 A I certainly had considerable involvement with it, yes.

1 Q We know earlier on that you were intimately involved in the dispute because we look in
2 bundle INT 2, which should be up there. Can you keep out that document you have just
3 been looking at in BT1, so you have it there as well. If we go to tab 3, which is again
4 towards the back, there is a bundle of various correspondence, and it has helpfully been
5 chronologically ordered. Can I ask you to go to p.165. As with all email chains, of course,
6 they go backwards. If we look on p.164, we see there is an email from Gareth Davies of
7 Ofcom to you specifically outlining the replicability and the PPC pricing model. At the end
8 we see that they are indicating to you in terms:

9 “... we have begun discussions with BT on the regulatory accounting
10 improvements ...”

11 That presumably is something to do with the RFS – yes?

12 A Yes.

13 Q If we go to p.163, we see an email from you to Gareth Davies copying various other people.
14 Catherine Galvin is, I think, an Ofcom individual.

15 A That’s right.

16 Q There you are:

17 “Thank you for sending this through, it’s very interesting and reinforces our
18 opinion that BT’s regulatory accounts have been materially understating the
19 returns made in these markets for some time as well as hiding differences between
20 internal and external supply.”

21 Then we see another email from you to Catherine Galvin in this train, and at the bottom of
22 p.162 we see an email from Catherine Galvin to you about the replicability and PPC
23 charging model, and we see that there is a specific meeting with you to discuss all of this.
24 Then on p.161 we have again an email from you to Catherine Galvin of Ofcom, and it sets
25 out a number of things about the RFS, and then on p.162, about a third of the way down, the
26 paragraph starting:

27 “Another issue that I’ve considered is the issue of sub 2Mbit/s trunk. The GL
28 revenues should include the actual sales of sub 2Mbit/s trunk ...”

29 and so on and so forth. So you have been intimately involved in discussions with Ofcom
30 about problems, as you perceive it in BT’s regulatory accounts, and indeed issues about
31 charging in connection with trunk from back to 2007, as we see from that. You say in your
32 witness statement that it was always your understanding that the primary purpose of LRIC
33 floors and
34 ceilings published in the RFS is for use as a first order test?

1 A That's right, yes.

2 Q Tests for compliance with BT's cost orientation. Can I ask you to look again at BT1, a
3 document we were referring to earlier. Can I ask you to look on to para.2.43, p.20. We see
4 there the start of the way you are putting your claim, the dispute request to Ofcom, and you
5 are saying:

6 "In the context of charge controls, Ofcom has consistently taken the view that the
7 appropriate rate of return is the weighted average cost of capital for the relevant
8 part of BT's business."

9 It goes on to discuss PPCs. Then over the page we have a series of tables that are put
10 forward, all of which are based on the ROCE from BT's accounts. Then what you do is
11 adjust those ROCE calculations. We see that in the second table, and that forms the basis of
12 your claim for overcharging, does it not?

13 A Yes.

14 Q Nowhere in this document that you have had such intimate involvement with do you
15 mention the fact that BT is breaching its first order DSAC test. That is right, is it not?

16 A I think that is right, yes.

17 Q There is no mention whatsoever in this document about DSAC?

18 A I think that's right.

19 Q So why, if you really thought that the primary ----

20 MISS ROSE: I am so sorry, but I think that question has been put on a false factual basis, if you
21 go to para.2.48 in this document.

22 THE CHAIRMAN: Mr. Harding, perhaps you could read that.

23 A (After a pause) Yes, we talk here about SAC ceilings and the gap between FAC and SAC.
24 I think there was a misunderstanding on Ofcom's part at the time of this because in the RFS
25 what I now know to be DSAC and DLRIC were called LRIC floor and LRIC ceiling. I
26 think at the time I mistook the idea of LRIC and SAC, as it's here, for the floors and
27 ceilings in the regulatory accounts because they're not marked DLRIC and DSAC. I think
28 actually I did cover that in my witness statement, if I can find it. It is para.108, half way
29 down, where I say:

30 "I accept with hindsight that this was slightly ambiguous, since we should have
31 referred to DLRIC and DSAC. The reason we did not use those terms is that the
32 cost benchmarks provided in BT's RFS were termed LRIC floors and LRIC
33 ceilings rather explicitly DLRIC and DSAC ..."

1 MR. READ: That is what you say, but the reality is, is it not, that at the time this dispute
2 submission was being put in you could easily see from the Regulatory Financial Statements
3 that BT was above the DSAC ceiling?

4 A Well, one could see that, but the real issue we had at this time was that we had very little
5 confidence in the information that BT was actually publishing. So Ofcom had done its
6 replicability and PPC charging work and it had found that the RFS for external sales
7 showed revenues 10 per cent lower than BT's own general ledger showed for the same
8 services, actual revenues from external CPs for PPCs. So there was a big problem then, and
9 within Ofcom's analysis of the general ledger revenues it showed that there were a number
10 of parts of the PPC product which weren't covered – the revenues weren't included in the
11 regulatory accounts, not for external customers or for internal customers. So it found that
12 about 17.5 per cent of external revenues were for third party equipment for resilience for
13 excess construction charges, one time charges, which didn't appear in the regulatory
14 accounts. We couldn't really place a great deal of trust on the information published in the
15 regulatory accounts that showed the average charge versus the ----

16 Q Mr. Harding, can you take core bundle 2, and can go to flag 31, p.1015. I understand your
17 bundle is not paginated – is that right?

18 A No.

19 Q Have you got tab 31?

20 A Yes, I'm on the dispute determination.

21 Q If you go to the internal numbering p.219, which is p.1015 in the consecutively paginated
22 core bundle 2, table A12.1. This is the data originally published by BT in its Regulatory
23 Financial Statements – do you see?

24 A Yes.

25 Q You can see there for 2005/06 2Mbit/s trunk was way above the DSAC ceiling – do you see
26 that?

27 A Yes.

28 Q For 2006/07, again way above the DSAC ceiling – yes?

29 A Yes.

30 Q Why, if you really thought that the primary purpose of the DLRIC ceiling was to be used as
31 a first order test, did you not say in that dispute submission, “Oh, and by the way, they are
32 actually above the DSAC ceiling in these respective years, it may be erroneous, but it still
33 shows that they have failed the first order test”?

1 A It does. We took this information and we got RGL to look at the level of recovery, if you
2 like, or return on investment, in PPC markets. It appeared to us at this time – this was prior
3 to the restatement – that the returns in all the different economic markets that Ofcom looked
4 at were way above BT’s cost of capital. To be honest, it looked very, very clear to us that
5 the charges were far too high and we chose to focus on what we were trying to get a
6 repayment from BT. Our negotiation with BT was us going and asking for a repayment
7 against excessive charges.

8 Q But this is not the document – the one we have been looking at in the BT1 file – that is
9 being put to BT, is it, it is a document being put to ----

10 A If I could explain. This document was written by our lawyers. We took the RGL report and
11 our negotiations with BT attempting to get this repayment to our lawyers, and we said,
12 “Look, to us it’s clear there’s overcharging, we’ve not been able to agree anything with BT,
13 BT would rather even not talk to us about it really”. What we asked our lawyers to do was
14 to write our dispute submission which we could refer to Ofcom which would maximise our
15 chances of getting the most money out of BT.

16 Q Mr. Harding, you have indicated that you had a fairly intimate involvement with putting that
17 dispute document together. We know that there is no reference at all to the DSAC ceilings
18 being exceeded, and we know that you had, from BT’s own Regulatory Financial
19 Statements, clear indications that in fact the DSAC ceilings were exceeded. Why, if you
20 really thought DSAC was the important test that you now say it is, did you mention nothing
21 at all about this excess by BT in its DSAC ceilings?

22 A Because the level of overcharging that appeared to us at the time, prior to this restatement,
23 to talk in terms of DSAC would be far too generous to BT. It appeared that the prices were
24 --

25 Q But why not mention it at all? You may have a point for saying: these are the DSAC
26 figures; they have been exceeded, therefore the first order test goes but, by the way, we
27 think it ought to be dealt with on this basis. But you mention nothing about it.

28 A We wanted more money.

29 Q But if the primary focus, as you say, the primary test, the first order test, was DSAC, should
30 you not have put that spin if you really believed the DSAC test was a true first order test?

31 A Once again, we asked our lawyers to write the file in a way that would maximise our
32 chances. I did review it along with all of the other CPs, we reviewed the drafting that they
33 did and we commented on it. In large part, we took their recommendation for how to
34 phrase the dispute referral.

1 Q Could I ask you to go back to the bundle INT2 which I hope is still out. It is the one that
2 had the correspondence in, you may remember. Do you still have that?

3 A Yes.

4 Q Tab 3. I would like you to look at p.141 which is a meeting on 8th March 2007 between
5 yourself, amongst others, and various representatives of Ofcom. Do you have that?

6 A Yes.

7 Q You can see that there is a specific discussion about PPCs, and Ofcom provided an update
8 on the PPC replicability, and Ofcom mentioned the work they had done to improve the
9 usefulness of PPC KPIs in the publication. Then it says at the end:

10 "Ofcom asked if it would be helpful for them to publish guidelines on particular
11 issues, in particular what they would expect where there was a cost orientation
12 obligation but they had not gone as far as to set prices or price ceilings. At the
13 meeting it was felt there may be some value and it was an idea that was worth
14 some further thought."

15 Do you see that?

16 A I do, yes.

17 Q Why should one need to public guidelines on cost orientation if it was so clear and obvious
18 that DSAC was the first order test?

19 A That was the first order test. I never understood it to be the only test. I don't specifically
20 recall it, but I would imagine that about at the time there was probably more to know for me
21 about what might come after that.

22 Q I suggest to you, Mr. Harding, that you are looking at this somewhat through rose tinted
23 spectacles and that in fact it was not as clear as you now say it was as to exactly how Ofcom
24 would approach cost orientation obligations.

25 A I'm sure that the benefit of time does see things slightly differently, but it doesn't get away
26 from the fact that, you know, I've made a lot of use of the BT Regulatory Financial
27 Statements and it says quite clearly in those on pretty much every page where it is looking
28 at service prices and costs, it shows the average price paid, a LRIC floor and LRIC ceiling
29 under a heading of Cost Orientation. So there's no doubt that over time things become
30 clearer, but that has always been clear.

31 Q So much so that there is no reference to the DSAC ceiling as being exceeded in the original
32 June response. Moving on to something else, one of the things you suggest is at para.36 of
33 your witness statement. If you want to turn that up you are free to do so. You say that the

1 delay in resolving the dispute was primarily caused by BT's restatement of its Regulatory
2 Financial in September 2008, yes?

3 A Yes.

4 Q If I have got the dateline right, you submit the request to Ofcom on 25th June and it is
5 accepted by Ofcom roundabout 25th July 2008. September 2008 is two months later, is it
6 not?

7 A Yes.

8 Q But we know that the Final Determination did not come out until October 2009?

9 A Yes.

10 Q How can you say, therefore, that the delay in resolving the dispute was primarily caused by
11 BT restating its accounts?

12 A At the time that we prepared the dispute we had got in front of us the RGL report that
13 showed what appeared at that time to be absolutely massive overcharging. We referred the
14 dispute and very soon afterwards, BT announced its intention to restate its regulatory
15 accounts, and it did restate its accounts and I can't recall the exact amounts. I think that in
16 there is a table that shows the impact of the restatement on the revenues and profitability of
17 the PPC markets as a whole. I think it is £230 million reduction in revenue from those
18 services as a result of the restatement. We were, to put it mildly, hopping mad as a
19 company to think that we'd been relying on BT's regulatory accounts to find that there was
20 such an overstatement of revenue which then got put right. It changed completely the
21 dispute that we'd referred. Now, for Ofcom, I think that they would quite rightly have
22 wanted to spend a great deal of time - indeed, we would not have let them get away without
23 spending a huge amount of time - investigating the causes and accuracy of the restatement.
24 So I think it's not fair just to look at the time between BT saying it was going to restate the
25 accounts and restating the accounts. I think you've got to look at the implications for
26 Ofcom resolving the dispute and satisfying themselves that the new figures were
27 reasonable.

28 Q So it is still your evidence that the 15 months delay in resolving the dispute was primarily
29 caused by BT's restatement?

30 A Yes.

31 Q That is still your evidence?

32 A Yes, certainly the delay to the Draft Determination was primarily because of that. I think
33 that we didn't expect that. The Final Determination we were waiting for - we had asked
34 Ofcom to wait for the next set of regulatory accounts, the 2008/9 accounts, to be published.

1 Q Could you have a look at para.1.8 of the Final Determination which you will find in your
2 core bundle 2 at tab 31 internal page number 4, the full pagination for the Tribunal's
3 reference is p.800.

4 "In this case, Ofcom decided that there are exceptional circumstances, most
5 notably BT's restatement of its regulatory financial statements. Within the
6 original four month period for resolving the Disputes we were informed that the
7 PPC financial data published in BT's regulatory financial statements which
8 formed the basis of the Disputing CPs' Submission was not reliable."

9 Pausing there, you had actually been told, had you not, by BT that in fact it was going to
10 restate its accounts and therefore you should desist from putting the dispute into Ofcom?

11 A I don't recall being told before we submitted the dispute, but that is just not my recollection.

12 Q Let me find the relevant document. (Pause) I will not take up more time looking for the
13 document because if there is a document we can no doubt refer to it in due course. Just
14 going back to para.1.8 it says there: "Reliable financial data did not become available until
15 October/November 2008." So Ofcom there are saying in terms that reliable financial data
16 was available in October/November 2008. You see that?

17 A That's what they appear to be saying, yes.

18 Q But you do not accept that?

19 A What I am saying is that just because the data that Ofcom felt was reliable became available
20 in October/November 2008 doesn't mean to say that they knew in October/November 2008
21 that it was reliable. They had quite a lot to do to look at it. We would have insisted that
22 they did look at that. We made a lot of comments at the time about probing, wanting to
23 know how could this be, and was the new information accurate?

24 Q Ofcom had their own independent auditors looking at the material, did they not? They had
25 concluded their investigations by October 2008, had they not?

26 A I don't know.

27 Q You do not know from your own recollection?

28 A No.

29 Q Can we move on. You suggested a number of potential problems in your statement that the
30 disputing CPs may have encountered. Can I ask you to turn in particular to one of these,
31 which is at para.62 to 64 of your statement which, if core bundle 2 is paginated in your
32 bundle at this point it is p.604 but if not, it is tab 19 p.16 of your statement. Do you have
33 that?

34 A Yes.

1 Q You make the point here that effectively BT supplies 155 Mbit trunk to itself without
2 terminating segment and can thus effectively use it to supply 63 x 2 Mbit trunk to itself
3 whereas the CPs cannot do that. That is the point you are making, is it not?
4 A That is, yes.
5 Q Mr. Tickel dealt with it in his second witness statement. I notice he was not cross-examined
6 on it. Do you now accept that is a wrong point?
7 A That's right. I had this information that I took from the accounts at the time. I've read Mr.
8 Tickel's statement on this point, and I have no reason to disbelieve what he said, so ----
9 Q So you accept that those paragraphs at the very least in your statement are wrong?
10 A Yes, I now think that I misunderstood that.
11 Q One of the areas you talk about, and actually we can see it on that page, because it has
12 "Wasted or Inefficient Investment", do you see that?
13 A Yes.
14 Q You say that that may have come about as a result of overcharging on trunk, do you accept
15 that that is what you are saying in that statement?
16 A Yes.
17 Q Can I just ask you now to turn to the draft determination, which I am afraid you will have to
18 get another bundle out, which is BT 1 again – I do not know if you still have that volume? I
19 am going to take you to this document. I am told it is confidential, but I know the bit that I
20 want to ask the single question about is not actually confidential itself, so if you can just try
21 and confine yourself to the page I am actually on. (After a pause) I am told I should be
22 taking you to a bundle that I am not even sure I have, which is up there, BT 5, I am sorry
23 about this. (After a pause) So that everyone knows what we are working from, it is a non-
24 confidential version of a number of the documents which are actually confidential in the BT
25 file, and I think it was expressly prepared for this purpose that certain of the witnesses
26 would not be in the confidentiality ring and therefore it needs to be dealt with. So if
27 anybody wants to look at it in the original BT document, it is BT 1, tab 4, which is the
28 confidential version of the draft determination. But the one I am now going to take you to, I
29 hope, is the version that is non-confidential, and is at tab 4 in that bundle as well. So I hope
30 if you go to tab 4 you can see the draft determination which says in terms it is the non-
31 confidential version. Have you been able to find that, Mr. Harding?
32 A Yes.
33 Q Thank you. I am sorry about that. If you can then turn to para. 6.22 which is at p.76 on the
34 internal numbering in that bundle. In BT 1, tab 4, it is also p.76 for anybody who is

1 looking, but it is also p.76 in your bundle as well. If you look at the bottom there it has a
2 bullet point: “Distorted investment decisions”, do you see that?

3 A Yes.

4 Q Towards the end of that paragraph there is a final sentence:

5 “Although widespread inefficient market entry does not appear to have happened
6 during the period of the Disputes, anecdotal evidence suggests that this was
7 because the Disputing CPs believed that BT’s trunk charges were too high and
8 expected that Ofcom would ultimately take action to reduce them.”

9 Now, do you agree with that?

10 A I think there is some truth in that. I can only talk about Cable and Wireless’s view, that is
11 the only one I have experience of, but for some time we had had a view that first of all trunk
12 prices, but then as time went on actually more generally PPC prices were high and we
13 expected them to come down, and certainly I would have been telling my business that my
14 view was that they were more likely to come down than go up. So there was that view in
15 business but certainly I do not think that that completely changed investment decisions that
16 we made. When it comes to making any investment decision it does not have to be a big
17 decision about going to a whole new part of the country, it is more likely to be installing a
18 new point of connection with BT, choosing what network to expand – do you put another
19 one in where you have already got one, or do you go to a new location, that sort of thing.
20 Decisions like that get taken by management, and management want to see real numbers.
21 They do not like it when people give a view, we might attract these customers, or we might
22 see prices change. They place most weight on analysis that has actual numbers, so the
23 actual prices that BT were charging us were absolutely what we would have taken
24 investment decisions on.

25 Q Even though?

26 A Even though people like me were saying: “The prices should be coming down, but ...” I
27 had said that for several years.

28 Q Mr. Harding, Ofcom here are analysing a dispute where they have had copious evidence,
29 material from the disputing CPs, not once in its original dispute determination submission,
30 but there were at least another two sets of submissions that were actually put in, were there
31 not, on behalf of the disputing CPs, and Ofcom clearly believe that no one was saying that
32 there had been any inefficient entry. That is what that paragraph is saying?

33 A Certainly, when I was talking about wasted and inefficient investment I was talking about
34 the investment that we make as a business month in month out, to expand our capacity to

1 put in new interconnects with BT, to rearrange the circuits that we have with BT, certainly
2 for Cable and Wireless in this period we were not building out trunk network to new
3 locations, but that is not to say that we were not making investments which avoided
4 spending money on buying trunk from BT.

5 Q Can I now turn to your second statement, and because this contains confidential
6 information, sir, I think I am going to have to ask for anybody who is not in the
7 confidentiality ring, apart possibly from anyone from Cable and Wireless, to actually leave
8 the room.

9 THE CHAIRMAN: Perhaps we can do that without rising, if that is possible?

10 (For proceedings In Private see separate transcript)

11 MR. READ: You would accept this, would you not, that the material that you have actually
12 referred to in the witness statements, none of that was put into Ofcom at the time of the
13 dispute resolution, the specific instances you give?

14 A The examples?

15 Q The specific examples you gave in your witness statements, most of that material was not
16 put before Ofcom at the time?

17 A I think that's right, yes.

18 Q And if we can have a look, please, at BT1, which I hope you still have there – do you have
19 that?

20 A Yes.

21 Q Could you go to tab 5.1. This is BT's response. I am sorry, it is another one of these
22 documents that ----

23 THE CHAIRMAN: I understand.

24 MR. READ: If you go to tab 5.1 in that bundle, this is BT's response of 5th June – yes?

25 A Yes.

26 Q If you go within that document to p.47, para.88 – do you have it?

27 A Yes.

28 Q It is the section dealing with economic harm, and 88 says:

29 "As BT made crystal clear in its Original Response, on the contrary, it is
30 fundamental to Ofcom's duties to have regard to the relevant factors set out in the
31 Communications Act 2003 and, in particular, to the requirements of section 3(4) of
32 the Competition Act 2003. It follows from those duties that a critical consideration
33 for Ofcom in resolving this dispute is whether the charging in question (looked at
34 in the round) has occasioned any competitive, economic or consumer harm

1 (described generically below, and in BT's Original Response, as 'economic
2 harm')."

3 Then para.89:

4 "No evidence to any alleged deleterious economic effect was adduced or introduce
5 by the Disputing CPs. They did not raise it as a crucial factor that was central to
6 the dispute. On a fair analysis, Ofcom would therefore recognise that there is no
7 evidence that BT's charging has occasioned any material distortion of competition
8 and/or cause any material economic harm in the present case."

9 That is what BT is contending at this stage.

10 A Yes.

11 Q If we go on in the bundle to 5.4, but I have an awful feeling that your bundle does not have
12 a 5.4.

13 A It doesn't have a 5.4.

14 Q I am told that it is actually in your BT1 up there. I am sorry to have to move you around
15 these bundles so much. Do you have that?

16 A Yes.

17 Q It should be, I hope, 5.4.

18 A I am looking at our response to BT's response.

19 Q Yes, that is right. The point I am making is that this is a specific response being put in by
20 the disputing CPs to BT's Response that we have just looked at. You understand how that
21 flows?

22 A Yes.

23 Q Then if you go to p.6 we see there at para.3 onwards what the disputing CPs' response is to
24 all of this. At 3.5:

25 "The Altnets repeat, therefore, their original contention that actual economic harm
26 or loss is not required to be shown as part of a decision to order reimbursement.
27 Nor is the question of the effect on the Altnets the only consideration to which
28 Ofcom must have regard in deciding whether to award reimbursement ..."

29 and so on and so forth. You knew, or it was known, that BT was saying, "There is no proof
30 of economic harm", and the Altnets' response is not to say, "Actually there is, and here it
31 is", their response is to say, "You do not need to prove it". Do you follow the point?

32 A Yes.

33 Q My point to you, Mr. Harding, is if you really had been suffering the types of loss that you
34 are now suggesting, why on earth was it not put in at the time in question?

1 A Again, I think it is quite clear from this response that what we are saying here is that we
2 don't believe that it's necessary to show that economic harm. I think that was the reason
3 that we didn't do it ----

4 Q Is the reality not that actually it is very difficult for you to demonstrate economic harm at
5 all, and that is the reason why you did not put the material in?

6 A No, I don't think it's difficult at all to demonstrate economic harm. I think it is difficult to
7 quantify the exact amount, but economic harm I don't think it's difficult to demonstrate that
8 it occurred.

9 Q Thank you, Mr. Harding.

10 Re-examined by Miss ROSE

11 Q I just have a couple of questions. Could you go back to the document that you were looking
12 at 5.4, I think you have it in BT1.

13 A Yes.

14 Q You were looking at p.6, and the point that was made at para.3.5 that the Altnets' contention
15 was that actual economic harm or loss is not required to be shown as part of the decision to
16 order reimbursement?

17 A Yes.

18 Q You see the footnote there, footnote 11:

19 "Notwithstanding, the Altnets repeat that considerable economic harm has
20 occurred as a result of BT's overcharging. The Altnets' original Response and the
21 RBB Report identified a large number of distortions with clear negative
22 consequences for the Altnets ..."

23 Then a number of paragraphs are given relating to the original response. If you turn back in
24 this same bundle to tab 5.2, this is, as you can see, the original Altnets' response of 2nd June.

25 A Yes.

26 Q If you go to p.45, para.7.6:

27 "... we agree with Ofcom that actual economic harm is not necessarily required to
28 be shown in any aspect of these Disputes. That is not to say, however, that it is not
29 present in the Disputes. As the RBB Report states, while Ofcom's Draft
30 Determinations do not rely on finding or proving any distinction, there is
31 nevertheless good reason to fear that economic distortions are likely to arise from
32 BT's charges."

33 Then two potential distortions are identified. The first at 7.7.1 is that;

1 THE CHAIRMAN: Yes, that is fine. I take it then that you do not wish to cross-examine
2 Mr. Robinson – is that right?

3 MR. READ: No, we managed successfully to agree after my ten minute sojourn on Friday that he
4 was not needed.

5 THE CHAIRMAN: Excellent. In that case we will rise for five minutes.

6 (Short break)

7 MR. READ: Sir, I will call Professor Yarrow.

8 PROFESSOR GEORGE YARROW, Sworn
9 Examined by Mr. READ

10 Q Professor Yarrow, I think probably for the sake of formality you ought to just briefly set out
11 your business address?

12 A 300 Banbury Road, Oxford, is that the one you have there?

13 Q That is your current business address, is it, or one of them?

14 A One of the two.

15 Q Can I ask you to take core bundle 2 at tab 25. There is a report. If you go to p.709 in the
16 bundle we can see that it has your signature and Dr. Decker's signature.

17 A Yes.

18 Q Firstly, can I ask you this question: do you adopt this report as your evidence?

19 A Yes, with the one qualification.

20 Q This is the first report.

21 A This is the first report? Yes, I do.

22 Q Just pausing there, can I just ask you, Dr. Decker has also had an involvement in that report,
23 is that right?

24 A That's correct.

25 Q Subject to anything you say in the course of examination, you stand by this report as much
26 as presumably he does?

27 A Yes.

28 Q Can I ask you to look at the second report which is at tab 26, and again at p.741 we see your
29 signature and Dr. Decker's signature. This is your supplementary second report. Is there
30 anything that you want to change in any way in this report?

31 A Yes. The number in the bottom of the paragraph. This was a change.

32 Q This is a change, is it? I do not think this is contentious, sir. It is dealt with in a
33 further submission. Is it para.75, the figures there?

1 A It is the £128 million and £541 million figures in that paragraph were wrongly calculated as
2 a result of reading figures from the wrong column in a spreadsheet of accounts. We notified
3 the Tribunal of that. I apologise again for that oversight. The numbers are so large that it
4 should have been spotted. They are out of line with everything else in the report and should
5 have been seen. My apologies for any inconvenience.

6 Q Subject to that point, do you adopt this supplementary second report as your evidence as
7 well?

8 A I do, yes.

9 Q Thank you, Professor Yarrow. If you just wait there I am sure there will be some more
10 questions.

11 Cross-examined by Mr. SAINI

12 Q Professor Yarrow, I think you have the core bundle in front of you. Would you please go to
13 p.710 which is at the end of your first report. Please tell me when you have got there.

14 A Yes.

15 Q You may want to refresh your memory as to the materials on which you relied in preparing
16 this report. Is that a complete list of the materials upon which you relied?

17 A That may well have to wait for a view from my colleague, Chris Decker as well.

18 Q Let us just stick with your own knowledge, first of all. You will appreciate from the facing
19 page, p.709, that you have given an expert's declaration there and having been a witness on
20 a substantial number of occasions, you will appreciate the importance of such a declaration.
21 You have said there in that declaration that subject to areas where you have relied upon
22 someone else's knowledge (and you identify that) the facts are matters that are within your
23 own knowledge you confirm to be true, and the opinions expressed are true and complete to
24 the best of your professional opinion. As regards the materials upon which you relied, I am
25 asking you in particular, not Dr. Decker. Are paras.1, 2 and 3 at p.210 complete?

26 A That I don't know because I am not quite sure what each of these letters referred to contain.

27 Q Let us take them one by one and help you on this. First of all, we have a copy of the Final
28 Determination. That is pretty self explanatory, is it not? That is the decision.

29 A Yes, that is what we worked from.

30 Q Then we have a letter of 13th July 2009, a letter of 15th July 2009 and a letter of 7th August
31 2009. Would you like me to take you to those letters?

32 Q Very well. I believe they are in BT3. Find 13th July first of all. I believe that is tab 11.3 if
33 you could go there. The letter appears to be mainly about combinatorial tests. Do you
34 recall this letter?

1 A Yes.

2 Q If you want to spend any more time looking at it in more detail please do so.

3 A OK.

4 Q Please let me know when you want to look at the next letter. You appreciate at this stage I
5 am just trying to identify what you say you relied upon.

6 A Yes. (Pause) OK.

7 Q If you go back one tab to tab 11.2 we see Ofcom's communication to Theresa Brown of BT
8 on 15th July 2009. Again, it is principally about combinatorial, but please do feel free to
9 look through it any further. (Pause)

10 A Yes.

11 Q And then the last one is a letter of 7th August, if one goes one tab back at 11.1. I think that
12 is there. It is again mainly about combinatorials. (Pause)

13 A Right.

14 Q You remember all those?

15 A I think I can.

16 Q Then item 3, back at p.710, appears to be a list of the estimates of return on capital
17 employed, they are not in the bundles, we have them loose if you want to look at them.
18 They are just basically sets of spread sheets, I am not going to ask you any questions about
19 those, but if you would like to look at them, you are welcome, they were supplied this
20 morning by Mr. Read, because I think everyone had forgotten they were not in the bundles,
21 but I do not want to take you through those.

22 A Yes.

23 Q So is this a complete set of the materials upon which you relied in preparing your report?

24 A To the best of my recollection. You are asking the question so presumably I have neglected
25 something.

26 Q Well I do not know ----

27 A To the best of my recollection, 3 is the crucial one in terms of what is important to this
28 particular case, if I may say so, and certainly we did rely on that quite heavily. Memory is
29 not perfect, as you will understand, Mr. Saini.

30 Q I understand, but you will also accept from me, will you not, that when you are preparing an
31 expert report, certainly as far as the facts are concerned, you must set out the relevant
32 documents upon which you ----

33 A Well I hope we have done that, as I say ----

34 Q -- prepared your report?

1 A -- as far as I know we have done that, but I don't know, if you are claiming not then I ----

2 Q Well can I just perhaps explain, Professor Yarrow, that there appear to be very, very
3 significant omissions in the materials upon which you relied in preparing your report. I am
4 going to go through them one by one. First of all, did you rely upon the 2004 LLMR
5 statement which is issued by Ofcom. If you would like to show me the document I will do
6 so?

7 A Yes, I mean we certainly refer to it. There are other documents clearly through the report
8 that we refer to, and all those references, clearly we have relied on. If you are telling me we
9 should have put those in the comprehensive list, then there will be several documents that
10 should go in that because there are several references and various footnotes.

11 Q So you did read the 2004 LLMR report?

12 A I didn't read the full report, I have read parts of the report.

13 Q And that should have been added there, should it not, because it is a very important
14 document?

15 A Well, is it? I don't think it's terrifically important for the issues before the Tribunal
16 compared with some of the other issues.

17 Q Let us just stop on that. Do you not think it is crucial because it is the document which led
18 to the setting of the cost orientation conditions which we are all arguing about?

19 A The cost orientation conditions are there so that we can look at and discuss in economic
20 terms what the cost conditions are without looking at the precise origins. We in fact go
21 quite a bit of the way back into the origins of the notion of cost orientation as a policy
22 through the various early European documents, which you will see referenced in the report,
23 so that again we could have put all those in the appendix and if you are telling me that I
24 should have done that, and if the Tribunal says we should have done that, then we should
25 have done that. The documents are there and referenced, where we are relying on them in
26 the report itself.

27 Q Is your professional view that the 2004 LLMR statement was not an important document?

28 A I think there are – I can't remember the exact parts that it refers to but it is certainly not
29 nearly as important, for example, as the sources referenced under item 3.

30 Q Let us look at another document, did you look at the 2004 Leased Lines Price Control?

31 A Yes, that was another document I think that was looked at, again if it was it will be
32 referenced in the report where it has been relied upon.

33 Q Can you recall what the determination was in the 2004 Leased Lines Price Control? What
34 was it about?

1 A The Leased Lines Price Control, that was when the price control was set and the issue in
2 effect was crystallised because terminating prices were set at very low levels which allowed
3 for the recovery of very little in the way of common costs from the terminating segment,
4 and therefore by implication allowed for larger amounts of cost recovery from other
5 products and that created the situation which we are analysing and trying to assess whether
6 the resulting tariff structures were cost oriented.

7 Q Is it your evidence that the Leased Lines Price Control of 2004 dealt with terminating
8 segments?

9 A It set price control for terminating segments, and then the other segments of course Ofcom
10 would have there significant market power assessments, and the cost orientation issues
11 would have applied to the trunk segments. But the actual price control was the terminating
12 segment.

13 Q So did the 2004 Leased Lines Price Control determine price controls for trunk segments?

14 A Not in the sense of a price cap.

15 Q Did it deal with the level of prices for trunk segments at all?

16 A Insofar as there was a cost orientation condition, then that places certain constraints on what
17 the level of trunk prices can be; that is the purpose of the cost orientation conditions.

18 Q I am not seeking to be disrespectful here, Professor Yarrow, would you accept it from me
19 that the 2004 Leased Lines Price Control fixed the prices for terminating segments ----

20 A Yes.

21 Q But did not fix any prices, or say anything about cost orientation for trunk segments?

22 A I can accept that it might not have said anything about cost orientation, the point I am
23 making is simply that there was also the cost orientation obligation on trunk segments
24 which is, of course, what the arguments are about.

25 Q Let us look at another document. Did you look at the Deloitte's report which concerns
26 benchmarking?

27 A Briefly, yes.

28 Q Sorry, what do you mean by "briefly"?

29 A Just turned the pages because we have not relied upon that. What we have relied upon is
30 the Ofcom treatment of that report and the issue we are raising was the dismissal of relevant
31 evidence by Ofcom, so in the discussion on the benchmarking issues, that comparison with
32 European Continental prices which show that the UK prices were not particularly out of
33 line, that discussion was based upon the Ofcom decision.

1 Q When you say “briefly” would it be fair to say that having looked at it briefly you were not
2 able really to form a view as to the quality of the evidence of benchmarking?

3 A We didn’t, no, that was not something that we have done. We are critical of the way in
4 which that evidence is dealt with by Ofcom, and that is the point we make. As for the
5 actual evidence itself, as you know, international comparison evidence always has to be
6 treated with caution. We use it because it is the best evidence we have got usually in many
7 cases, and therefore even though it is highly imperfect evidence, being the best evidence it
8 should always, as a matter of good practice, be considered carefully. Our reading of the
9 Ofcom documents and the Ofcom arguments was that Ofcom was very keen to dismiss this
10 evidence without good ground, and that was plain on the face of the decision and did not
11 need any detail. I took the fact that it is a Deloitte’s report, Deloitte has lent its brand name
12 to it so I will count that as a factor, but it was not something we were specifically asked to
13 address; remember we were asked to address a number of questions and we didn’t do that in
14 any great detail.

15 Q So would it be fair to say – I think you have already said this, but correct me if I am wrong
16 – you did not assess the quality of the evidence in the Deloitte’s report, your concern was
17 that Ofcom, I think – your words – appear to have “dismissed it”?

18 A Yes, that was in chief.

19 Q Then let us look at another document, did you consider the 2008 business connectivity
20 market review?

21 A I believe Chris read that, I didn’t look at that.

22 Q You have not read it?

23 A I haven’t looked at that.

24 Q Okay, then how do you feel able to provide this report which you have signed up as
25 representing your own views? Is it fair to say that as far as any issue concerning the
26 Business Connectivity Market Review is concerned you have no knowledge?

27 A That would be a reasonable first approximation, I am not sure that I have no knowledge, but
28 it was not a document that I paid much attention to.

29 Q Did you even read it?

30 A I don’t think I read it.

31 Q Have you considered any of BT’s primary accounting documents?

32 A What do you mean by “primary”? We certainly looked at the Regulatory Financial
33 Statements.

1 Q Perhaps I can show you a document rather than you guessing in relation to this. If you
2 would please take up bundle ADB4 and if you would go to tab 6 in that bundle?

3 A Yes.

4 Q If you look at the first page it is called “Primary Accounting Documents”?

5 A I have it.

6 Q You may just want to flick through, there are no figures in there, this is mainly tests
7 describing the way the primary accounting documents are formulated. Do you recall seeing
8 this document?

9 A I certainly did not use it in this particular case. It may be that I have seen it in another
10 context.

11 Q Well if you can just restrict yourself to this case, for the purpose of preparing your report,
12 you have not seen this document – can we take that to be your position?

13 A Yes.

14 Q Thank you very much. If you can put that away please. I believe throughout your report
15 you place significant emphasis on Ofcom’s alleged failure to take into account BT’s
16 international benchmarking evidence, you accept that, do you not?

17 A It is one of the points.

18 Q Would you like me to remind you where you deal with this, because again I do not want
19 you to be guessing?

20 A Yes.

21 Q If I can give you an example, para. 18, p.667, if we look at the third line there, there is a
22 reference to a table and then these figures being “underpinned by benchmarking evidence”,
23 that is a short reference but it is actually dealt with in quite a bit more detail – I am sure you
24 will recall – at p.682, para.71 et seq. Also, just to be complete, para. 117 you will see at
25 p.693 there is a whole heading: “Consideration of international benchmarking evidence”?

26 A Yes.

27 Q Would you agree with me that the use of international benchmarking evidence is difficult
28 because although we know that price control obligations have been widely imposed in the
29 European Union the methods for controlling prices varies significantly from one country to
30 another, and then one sees divergence in prices of comparable services. Would you agree
31 with that?

32 A Yes, it is a difficult exercise as I have I think already said.

1 Q Is it not the case that you yourself in your report, although in a different context, cite that as
2 being the position of the European Commission. Perhaps I can help you, p.672, and if you
3 would please go to footnote 21, perhaps you can read that to yourself?

4 A Yes.

5 Q That is your own view there – it is not your own view, it is your recording the view of the
6 Commission?

7 A Absolutely.

8 Q So what, on their face may appear to be comparable services or products, may have very,
9 very different levels of charge because the methods for controlling those prices vary
10 significantly in the Community, do they not?

11 A They do and I think the statement from the Commission Working Paper is indicative of an
12 important point which is that cost orientation is not intended to be a prescriptive way of
13 setting prices in general. It's designed to give latitude for prices in order to help manage the
14 transition from regulated markets to deregulated markets, and you will note that the
15 statement, the reason we give it is that the paper is noting that even where there is cost
16 orientation – even where there is cost orientation – there are quite marked differences in
17 prices to be observed. That is a good illustration of the latitude that's to be allowed under
18 the cost orientation obligation. If I may say so, the first point that you raise where we first
19 raise it, you will see again that our concern is not to explore and try and be a reviewer for
20 Deloitte but rather to know that the way in which Ofcom dismissed this evidence is they say
21 that this evidence has difficulties, and faced with that and faced with what they call actual
22 cost data, then it's obvious that you should choose the actual cost data. If you think about
23 it, the word "actual" there is simply trying to make the cost data much more objective than
24 it actually is, because the fundamental economic point in this whole case is that allocation
25 of common costs is an arbitrary accounting exercise. That is the central point that we try to
26 get across. The treatment of international benchmarking is another illustration of the way
27 Ofcom fails to recognise the arbitrariness of the cost allocations that have gone on.

28 Q Professor Yarrow, you, yourself, have said that you formed no view as to the quality of the
29 information that Deloitte's have put forward. That was your evidence, was it not?

30 A Other than the fact that it is a Deloitte's report and therefore I make the normal assumption
31 that that's a sign, it's an indicator. All of these pieces of evidence are indicators. It's part
32 of the way we look at problems to recognise that no one piece of evidence is likely to be
33 decisive on its own. Although, I think there is a fairly decisive piece of evidence in this
34 case. Generally, what you are doing is piecing together lots of bits of different evidence to

1 see if it stacks up. Our interest in the international costs benchmarking data was that it
2 showed that the UK prices were pretty much in line, there wasn't anything obviously
3 deviant about them. That went alongside other, I wouldn't say "finding", our other
4 interpretation of what Ofcom said in its decision that there hadn't been much new entry. If
5 prices are basically okay you don't expect a lot of entry. That fitted too with what is the
6 much more decisive piece of evidence which is that when we looked at what the CPs were
7 actually paying for what they bought, then as far as we could see, and this was a number we
8 asked BT to give us and this was the statements referred to under the third point in that
9 appendix about what we relied on – what we discovered there, at least if that information is
10 reliable, is that the CPs were being supplied at prices for PPCs as a whole which were less
11 than cost. I am using "cost" in the economic sense of including a normal rate of return on
12 capital. That was the first question that we asked, and that number comes very early in the
13 report. If you are looking for excessive pricing or something wrong with cost, the first thing
14 you do is to look at the average price level for what people are buying the bundles. You
15 look at the individual prices second. What we were finding was that, according to this data,
16 the CPs were not only not paying the price which gave an above normal rate of return on
17 capital, but were actually buying at less than full cost, including their return on capital.
18 That piece of evidence is a very weighty piece of evidence. So we are looking at all these
19 things together and putting them together without looking, in the case of the international
20 benchmarking evidence because of lack of time; we are not going and doing an assessment
21 exercise on Deloitte.

22 Q Professor Yarrow, I do not want to stop you, and I deliberately did not stop you there, I am
23 focusing at the moment on international benchmarking, and I am going to give you a chance
24 to say whatever you like in relation to rates of return. Let us just fix on that for the moment.
25 As I understand it, you have briefly looked at the Deloitte's report – that is correct?

26 A Yes.

27 Q You did not form any view as to the limitations there may be in that data because you
28 looked at it briefly – is that correct?

29 A I looked at it briefly, and I know from other international comparisons that it's an issue that
30 comes up. As the Tribunal will know, these things have appeared in Monopolies and
31 Mergers cases from time immemorial, that there are always difficulties. You would never
32 get the perfect control experiment. It's part of the problem that we work with in economics
33 and other social sciences. I would not normally, as a matter of practice, treat that sort of
34 evidence as decisive in a particular case. It would just be one thing to look at to see if there

1 was any indication that the conclusion that the rate of return evidence was suggesting was,
2 in fact, false. It's another piece in the jigsaw.

3 Q Let us not go to rate of return. Would you accept from me that there are significant
4 limitations on the reliability of the Deloitte's report?

5 A I would imagine that there would be, and from what I saw I would say, yes, there would be
6 significant limitations.

7 Q If you have got your witness statement there could you please go to p.682. Would you look
8 at the first line of para.71, please, if I may read. Under the heading "*Relevant market*
9 *evidence is discounted*":

10 "The international benchmarking evidence presented by Deloitte is dismissed, for
11 no very good reason."

12 Can we stop there for the moment. How are you able to express that as an expert view, not
13 having considered in any detail the actual Deloitte's report?

14 A Because Ofcom don't give any good reason for dismissing the evidence. What they do,
15 again I repeat, they say, faced with this difficult, we all admit it is difficult, international
16 benchmarking evidence and comparing that with what they call actual real cost data – I
17 don't know the exact words but actual cost data – they say, "We prefer actual cost data".
18 That actual cost data is arbitrary. There is no basis for making that judgment and therefore
19 we conclude they had no basis for dismissing the international benchmarking evidence
20 because they did not, as a matter of fact, have better evidence.

21 Q I want you to stop there. Let us just fix on this sentence. You have not even looked at the
22 Deloitte's report for the purposes of assessing its limitations, yet you feel able to say that
23 Ofcom dismissed it for no good reason. Is that not a rather odd position to take as an
24 expert?

25 A No, I think it's an absolutely logical position to take, and I have just explained it. We did
26 look at it. We looked at it briefly, I've said that. It looked to have the normal limitations.
27 Normal practice is to work with best available data. Ofcom dismissed it because they
28 claimed they had better available data in the form of actual cost data, as they called it. They
29 didn't. They dismissed it for no good reason.

30 Q We are not going to agree on that, but would you accept that as a basic prudent measure,
31 before one says that a regulator has dismissed a particular piece of evidence for no good
32 reason, you look in detail at that evidence, do you not?

33 A I would look at the reasoning. It's a statement about the reasoning of the regulator. If the
34 reasoning is incorrect it doesn't matter.

1 Q Who read the Deloitte's report, albeit briefly? Was it you or Dr. Decker?

2 A I believe we both looked at it.

3 Q I think you have already agreed with me, you were not able to form a view as to the quality?

4 A It was not part of our task to assess the quality. One has large numbers of tasks to undertake

5 in life. That was not a priority. It's not a priority or a major part of the argument, other

6 than as a piece in jigsaw.

7 Q Can I leave the issue of the benchmarking data for one moment, please, Professor Yarrow,

8 and ask you about the cost orientation conditions that were imposed. What is your

9 knowledge of the two conditions that are in issue here. First of all, tell us, what is your

10 knowledge of what the condition was for trunk segments?

11 A For trunk segments I believe that it was that prices should be – is it “reasonably derived”?

12 If I can find the place, we ask two questions. We draw the attention of the Tribunal to the

13 two crucial questions, “Are prices reasonably derived from” – I think it was LRICs, but

14 could somebody give me a hand?

15 Q Perhaps I could help you. Would you go to ADB2, please, and perhaps I can just show you

16 what this document is because you may or may not be familiar with it, the LLMR statement

17 of 2004, if you want to look at the first page of it. It is a fairly lengthy document, the date

18 of 24th June 2004. It does not have the date on it. This is the LLMR statement which, just

19 in case you do not know, is the document that led to the imposition of these conditions. If

20 you would please go to p.480, that is the condition that applies to trunk segments, if you

21 want to refresh your memory?

22 A Yes, “reasonably derived from the costs of provision, forward looking long run incremental

23 cost”, which is what I was recollecting first and then secondly, the crucial “allowing an

24 appropriate mark up for the recovery of common costs and appropriate return on capital”.

25 Q Are you aware that the condition that was imposed for terminating segments was different

26 in the sense that a price control was imposed?

27 A Yes.

28 Q And are you aware that Ofcom undertook a market analysis and concluded that there should

29 be different conditions for the two different markets?

30 A Yes.

31 Q What is your understanding, Professor Yarrow, of why they decided to impose a price

32 control for terminating segments and this basis of charges obligation for trunk segments?

33 Perhaps you can share your knowledge with us.

1 A Yes. I think that would be the standard policy. The general policy in telecoms is to
2 deregulate where possible. What the regulator has got to do is to look and see whether, in a
3 sector area, deregulation would, in fact, lead to a situation in which prices would
4 subsequently be constrained by competition. So it is a difficult area because it is a
5 transitional kind of policy. What Ofcom would have looked at, and I believe they did, and I
6 certainly think they did this correctly, is areas where they believed that there were more
7 alternatives for buyers to BT than other areas. The conclusion I don't doubt in this
8 particular case, is that Ofcom judged that in terminating segments there weren't any really
9 viable, easily available alternatives to BT services. Within the trunk services then there was
10 possibility that other telecoms providers could provide those services, and indeed of course
11 the CPs could self provide, they could build their own kit because we're dealing with areas
12 which, if I can put this rather loosely, are further away from being naturally monopolistic.

13 Q Would it be fair to say (and again I do not want to be disrespectful in this, Professor
14 Yarrow) that you do not really know why Ofcom decided to impose these different forms of
15 regulation, because you are not actually very familiar with the LLMR report?

16 A I'm very familiar with Ofgem's policies and --

17 Q We are dealing with Ofcom here, not Ofgem.

18 A Sorry, Ofcom. I am very familiar with Ofcom general policies.

19 Q Let us put aside please the general policy. Would it be fair to say that you really do not
20 have any personal knowledge because you have not really focused on the 2004 LLMR
21 statement.

22 A I haven't read the LLMR statement, but I've read what Ofcom says about the policy in the
23 later documents, including the decision document and the other documents that are
24 referenced. I mean, this is not rocket science. Regulators look to see where they can lift
25 tight controls and what they're concerned about is whether, if they do that, buyers will have
26 alternatives which will be sufficiently viable and realistic to constrain what prices will be
27 set in those areas. It's a universal policy, just about, across the sectors. Telecoms is not
28 different. Ofcom talks about it in other documents. It's not a policy or an area where you
29 need to read a specific document. The specific document will tell you the historical record
30 of what Ofcom did at that particular time in relation to these particular things, but, you
31 know, if one spent one's time reading every regulatory document that was produced in
32 government you would never have time to think. Our job is to think mostly.

33 Q Can I take from your answer, Professor Yarrow, there is not much point in my asking you
34 any questions about this document?

1 A Not the specifics. If you want to ask about the policy or about cost orientation, I am very
2 happy to.

3 Q But would it be fair to say that you did not read this report (I appreciate it is very lengthy)
4 prior to giving your professional views?

5 A I think I read half of this report. I think I said that already.

6 Q OK. Could you identify for us which parts of it particularly you read?

7 Q No, I really couldn't, I really couldn't. We do lots of things, we read lots of documents.
8 This is not rocket science. I am helping the Tribunal as a professional in the regulatory
9 area. If you want to ask me what para.55 says on a particular point I have no idea.

10 Q Would it be fair to say that not only relates to the LLMR report? Would you please go in
11 the same bundle at divider 4. This is the Partial Private Circuits Charge Control. This is the
12 document which led to the imposition of the price controls, or rather the formulation of the
13 price controls on terminating segments. Would it be fair again to say that you did not read
14 this document?

15 A That's correct. I in fact read more of the later document, the 2009 document.

16 Q Do you mean the Business Connectivity Market Review?

17 A No, the Leased Lines Charge Control.

18 Q That is the one at divider 4. That is 2004.

19 A There is a 2009.

20 Q I do not think we looked at that. It is not going to be added to our bundles.

21 A It is actually a very crucial document for the Tribunal though.

22 Q I do not think that BT has decided that the Tribunal needs to see it, so I am not going to
23 introduce it now! Tab 4, which is what we were looking at, as I understand it you did not
24 look at that document?

25 A No, we read what Ofcom said about it in its decision and that seemed sufficient for our
26 purposes.

27 Q Were you aware that in 2004 Ofcom concluded that a stringent test for cost orientation had
28 to be imposed upon trunk segments because Ofcom did not believe that simply relying upon
29 the Competition Act to prevent excessive pricing would be sufficient?

30 A I am not aware of any statement where it said a stringent test.

31 Q Perhaps you would look back to a document that is at the first divider at p.192. This may be
32 the first time you are seeing this, and I do not seek to criticise you for that. Would you
33 please look at para.8.42.

1 “It might be argued that the Competition Act should be used to avoid excessive or
2 predatory pricing. However, Ofcom considers that sectoral tests are likely to be
3 more stringent and more effective than the Competition Act, giving the SMP
4 communications provider less latitude and providing greater certainty for access to
5 customers.”

6 That was a regulatory conclusion that Ofcom reached in relation to trunk segments in 2004.

7 Do you see that?

8 A You asked me whether it is stringent. This is a relative statement, it says “more stringent”.
9 Clearly, if you’d asked me whether a more stringent requirement was required I would have
10 said yes, because that’s the cost orientation obligation. But it’s degrees. Stringent would
11 imply a much more cautious approach to deregulation and a different policy decision. That
12 was why I was surprised when you said “stringent”, because if they had said stringent they
13 would have implied a relatively lukewarm commitment to moving in this direction and
14 generally, certainly at that stage, my impression is that Ofcom was not in that space.

15 Q OK. We have seen the particular stringency that Ofcom was seeking?

16 A Yes.

17 Q If you want to remind yourself perhaps we can turn up the specific cost orientation
18 condition for trunk segments. Just to remind you if you would like to look at it again it is at
19 p.480. Perhaps you can turn it up.

20 A This is the same document?

21 Q Yes. This is to help you in recalling the words of the condition for the moment. If you can
22 read condition H3.1 to yourself. It says: “Unless Ofcom directs otherwise from time to
23 time, the Dominant Provider shall secure, and shall be able to demonstrate to the
24 satisfaction of Ofcom, that each and every charge” and I will not continue any more. I just
25 want to focus on the first three lines, please. Would you agree with me that when policing
26 this obligation there are fundamental differences between this type of ex ante obligation and
27 an ex post Competition Law obligation such as an obligation not to price excessively?

28 A Could you just repeat the question, because the economics is basically the same but I think
29 you may have asked me something slightly different.

30 Q Perhaps I can break it up by focusing on this condition. Let us imagine two different
31 situations. One is a situation of an enforcement of a basis of charges obligation - an ex ante
32 obligation. Do you accept this is an ex ante obligation?

33 A Yes, this is an ex ante obligation.

1 Q A classic ex post obligation would be, for example, an obligation not to abuse dominant
2 position by pricing excessively, such as in the Napp case?

3 A Yes.

4 Q One fundamental difference between the two is that in the ex ante case, as in the condition
5 of H3.1, the burden to show cost orientation is upon BT.

6 A I'll take your word for that. That's a legal point.

7 Q Can we just look at it? It is not a legal point. It just says "shall be able to demonstrate".
8 You are well aware, because you spent some time in your report taking us through the Napp
9 decision, of that case, are you not?

10 A I'm fairly familiar. It's a long time ago. If you ask me what para.55 says, I won't be able to
11 answer.

12 Q By contrast, in the Napp case, we have the regulator bearing the burden of showing (a) that
13 Napp had a dominant position; and (b) that it had priced excessively. Do you recall that?

14 A Yes.

15 Q So would you agree with me that there is a fundamental difference between the way that ex
16 ante and ex post obligations are policed?

17 A There is in the burden of proof sense, yes.

18 Q You will also agree with me, will you not, because we have looked at this part of the LLMR
19 statement, that Ofcom decided that they could not just rely upon enforcement of ex post
20 competition law, it had to have an ex ante obligation?

21 A That was a conscious decision. That's why this exists.

22 Q Thank you very much. Are you aware, in relation to the terminating segments (and tell me
23 if you are not aware and I will not go any further with this) an RPI minus X type of price
24 control was imposed?

25 A Yes.

26 Q Could you please articulate for us what the rationale is for regulators trying to impose that
27 type of price control?

28 A The rationale for a price control?

29 Q For a price control such as the RPI minus X type price control.

30 A The principal object there is to protect consumers by placing boundaries on prices to
31 prevent the exploitation of market power.

32 Q Would you also agree with me (and I do not think this is a matter of dispute between the
33 experts but tell me if it is) that one of the reasons for imposing an RPI minus X price control
34 is to create incentives for the company which is the subject of the control?

1 A All regulation tries to put in incentives for cost reduction where it can. It does it in different
2 ways. RPI minus X does it in its own way. It's not terribly different from rate of return
3 regulation in practice, so there's not a bright line kind of difference between RPI minus X
4 regulation and rate of return regulation in terms of impact on costing centres.

5 Q Would you agree with me (not talking about any particular case at the moment) that in order
6 for an RPI minus X type of price control to be meaningful it is important that a regulated
7 company, here BT, does not try to compensate for under recovery of costs under that
8 control -- let me just finish my question, please, before you shake your head. That a
9 company such as BT does not try to compensate for under recovery of costs by charging
10 more for another service?

11 A That's not part of the primary purpose of any of this. If that was the primary purpose, that
12 would be a profit control. In the 1980s the UK deliberately, consciously decided not to
13 impose profit controls on firms but to impose price controls through the formula you have
14 mentioned: RPI minus X. Profit control was considered. I remember Alan Walters, among
15 others at that time, who was advising Mrs. Thatcher, wrote a paper on it. But profit control
16 was rejected. What you are talking about is profit control.

17 Q All I am talking about is actually a very simple point. We do not need to go to Alan
18 Walters. A simple point which is that when a price control is imposed the regulator and the
19 public expect the price control is going to be respected; they do not expect that the price
20 control, or failures in the price control, are going to be made up for the regulator entity
21 through other charges.

22 A I wouldn't pretend to speak for what the public expects, but that's not the primary purpose.
23 The primary purpose is that for terminating segments customers have little choice and
24 therefore the price cap protects the customers. That is the primary purpose. These other
25 things are secondary and are not the primary policy purpose.

26 Q I do not think we are disagreeing about that issue. Would it be fair to say that the precise
27 inter relationship between trunk and terminating charges which were the subjects of these
28 reviews, you cannot really say anything about those because you are not really familiar with
29 the 2004 documents?

30 A In what sense?

31 Q You are not familiar with first of all Ofcom's reasoning for the precise terminating segment
32 price control, Ofcom's reasoning for the particular basis of charges obligation imposed for
33 trunk. You are not familiar with those, are you?

1 A I'm not familiar with the detail, but I am familiar because it is discussed in the later
2 documents. Again, not everything is in just one document. These things are discussed
3 endlessly in regulatory circles. The fact is that in 2004 a deliberate and conscious decision
4 was taken not to allow BT to recover very much in the way of common and fixed costs from
5 the terminating segment. I'm also aware that the immediate implication of that, since there
6 is a pot of fixed and common costs, is that Ofcom must have known that BT would need to
7 recover those costs from elsewhere. That's why I say to the Tribunal the 2009 leased line
8 control is perhaps more interesting because Ofcom there recognises that point very
9 explicitly and moves £55 million worth of revenue recovery from trunk into - well, not from
10 trunk but into terminating. Again, when one comes to a problem one focuses on key points
11 rather than waste a lot of time reading stuff which is only secondary. The key point about
12 that particular decision is the way in which Ofcom approached the recovery of common
13 costs, which, as you see, is the final and important part - and the disputed part really - of the
14 cost orientation obligation. How do you determine what is appropriate?

15 Q I am not going to spend any more time going through these documents with you, because I
16 believe, to be fair to you, you have a very general knowledge having looked at these
17 documents in preparing your report. Is that correct?

18 A I have a general knowledge and I have specific knowledge, I believe, of the things which
19 are most relevant to the Tribunal's assessment.

20 Q We have seen that the condition (and we can look at it again if you want to) imposes a
21 requirement upon BT itself to show that its charges were cost oriented. You recall that, do
22 you not?

23 A Yes.

24 Q As I understand your instructions, the way in which BT discharged that obligation was
25 through aggregating the costs of trunk and terminating and thereby considering that DSAC
26 was satisfied, is that correct?

27 A You are talking about compliance with the conditions, that is partly a legal matter. I had
28 assumed that the way in which the reporting worked, this really is a question for BT and for
29 Ofcom, is that BT prepare Regulatory Financial Statements which had in them things like
30 DSAC columns, LRIC columns, and they presented data on rates of return, on capital and
31 you could go to that and work out all these various things for the various services. So at
32 that reporting level you could see trunk and the various components of trunk listed
33 separately, and you could work out the rate of return on capital separately. Now, one of the
34 things we asked for because we thought it was rather important, if there was an argument

1 about overcharging one of the things we asked for was for BT, who knew those accounts
2 better than we did, and where we knew they were there, to produce for us numbers of what
3 the rate of return was that BT was making on the supply of PPC services together to the
4 customer. The reason for that is because if there is an exploitation abuse of some sort, or an
5 exploitation violation of the condition, if some customer is paying more, what matters is
6 what the customer is buying, it is the customer across the piece. I mentioned Ofgem, but if
7 I can give an analogy from the energy market, when a Regulator in energy would look at,
8 let us say, a household and look at what they were buying, the primary interest, if they were
9 a dual fuel customer of a particular supplier would be what the deal was like as a whole as
10 between electricity and gas. But, on the other hand, the Regulator may be interested in only
11 the electricity price if there was a bunch of customers, as there are – and a very difficult
12 bunch – to deal with, customers who use only electricity and not connected to the gas
13 system. In this case – I am glad you have gone this way because this is what I always say,
14 cases are simplified by the facts. The fact is that the CPs all bought terminating and they all
15 bought trunk and they bought them in varying proportions, but they all bought both.
16 The simplest first question to ask is: “How much money does BT get out of these customers
17 buying these services?” and that was one of the first questions we asked.

18 So we looked at it together because the customer buys together, and that’s the reason ----

19 Q Let us put aside what you did, I want to understand your instructions from BT. We have
20 seen that it is for BT to show that it is complying with the cost orientation obligation?

21 A Yes.

22 Q As I understand your report, what BT have told you is that the way that they satisfied
23 themselves that they were complying with the DSAC test was by aggregating between trunk
24 and terminating, now is that correct or not?

25 A No, no, it’s not correct. We didn’t ask that question.

26 Q Okay, perhaps I may have misunderstood your report, if you would please go to p.692 in
27 your first report, para. 111, if I may read that – this is after your description of DSAC is a
28 screening test:

29 “On this basis (that comparing prices with DSACs is a screening test), the view
30 might be taken , and we believe it is a view that was taken by BT, that sets of
31 products with prices that all fall below the relevant DSACs are highly unlikely to
32 give rise to concerns that cost orientation obligations have been violated.”

33 A. Yes.

1 Q As I understand it, you were instructed by BT that that is how they believed they were
2 complying with DSAC. Is that correct?

3 A No.

4 Q So what does that mean?

5 A It means that the Regulatory Financial Statements were pretty transparent about what was
6 happening to DSACs and so on for the individual products, everybody could pick them up,
7 and since you can see observations where some products were below DLRICs, and some
8 were above DSACs, and since Ofcom hadn't jumped on that and since BT didn't seem
9 particularly bothered about it, we inferred that they took the view – which we think is the
10 right view – that in relation to DSAC, and we should come to DSAC, when you are dealing
11 with DSAC, which is a separate set of issues, that what you need to do is to take a rather
12 general overall approach to what the pattern of prices and costs are to produce several cost
13 orientation obligation questions.

14 Q So it is your inference from the existence of the Regulatory Financial Statements that that is
15 what BT were doing? You were never told that by anyone, you inferred it?

16 A We inferred it and also it seems to me to be the rational interpretation. If you were going to
17 use DSAC which, I think the Tribunal have already heard, is a very unusual concept without
18 any pedigree in economics, if you are going to use this rather unusual concept you had
19 better use it rather cautiously, and therefore not just do a mechanistic calculation of a single
20 product or a single small set of products.

21 Q As I understand it, you accept that one of the major factors that a Regulator should consider
22 when considering excessive pricing is rate of return?

23 A It is a simple early factor that you can look at, yes.

24 Q Sorry, I did not hear that?

25 A A simple early number that you can look at, which is what we did, I mean that's why we
26 went to it, the rate of return of capital employed.

27 Q Would you accept that, putting aside trunk and terminating, we are not going to put them
28 together but just let us take them separately for the moment, and please go along with me
29 this far, which is that if one looks at trunk segments, alone, and I know about all the
30 qualifications etc about why you would want to do that, that DSAC allowed BT to earn a
31 very substantial rate of return?

32 A Yes.

33 Q And you have no reason to disagree that on average this allowed a return on capital of about
34 54 per cent?

1 A That sounds about right.

2 Q Your concern, however, about DSAC in relation to trunk segments appears to be that it does
3 not provide much latitude for the regulated companies, is that correct?

4 A When evaluated in the full context, yes.

5 Q Well let us just deal with it as far as trunk segments are concerned on their own?

6 A You cannot, you cannot do the economics on this basis. You cannot ignore evidence that is
7 relevant to the question. Even if you evaluate in one place you take into account all
8 evidence relative to the assessment of that price, so it is an evidential and it is an analysis
9 point. You simply cannot talk sensible economics on a price by price basis.

10 Q Ultimately the Tribunal is going to have to decide whether or not one looks at rates of return
11 on an aggregated, or disaggregated basis, you understand that?

12 A I can understand that.

13 Q On a disaggregated basis, in other words, looking at trunk on its own, would you accept that
14 DSAC allows very substantial flexibility in pricing? I know you do not accept the premise,
15 but ----

16 A No, but substantial certainly relative to – everything is relative so let us fix this, and I do not
17 think there will be any disagreement – relative to a price capping approach, which would fix
18 the price at or near some sort of cost of capital if you were doing it on a case by case basis.
19 So relative to that obviously it allows a fair amount of variation.

20 Q So relative to, for example, fully allocated costs it is extremely flexible, is it not?

21 A Oh yes, fully allocated costs, if you were required to price it at fully allocated costs that
22 would be a single number, whereas if you allow it under the cost orientation condition to
23 price to something like DSAC then you have a wider range of choice, clearly.

24 Q Perhaps I could help you by showing you a part of Mr. Myers' statement, it is in the same
25 bundle, as your witness statement, it is p.495, para. 37?

26 A Yes.

27 Q I do not know if you have a confidential or non-confidential version, do you have some
28 numbers in bold?

29 A I have some numbers ----

30 Q Okay, well I am not going to refer to those numbers, or indeed in open court to the table.
31 But as I understand your evidence, I believe that you have read Mr. Myers' statement
32 before?

33 A Yes, I have, yes.

1 Q When one is dealing with the flexibility provided by DSAC in relation to trunk , there does
2 not appear to be a dispute?

3 A What do you mean by a “dispute”?

4 Q If one looks at para. 37: “The DSAC approach, therefore, still provides for substantial (but
5 bounded) pricing flexibility”, and Mr. Myers explains at 37 (a), (b), (c) and (d) with the
6 table, which I am not going to refer to, as to why he says there is “substantial (but bounded)
7 pricing flexibility”?

8 A There is substantial flexibility if you look it only on a single product basis. When you look
9 at it in the round, DSAC turns out to be highly constraining and that is part of the problem.
10 DSAC does not allow you to make a normal rate of return on PPCs. So looked at on an
11 individual basis it looks as if there is a lot of pricing freedom, but that pricing freedom is
12 taken in conjunction with other factors that matter, and not enough, that latitude is not great
13 enough to allow the company to make a normal rate of return. It is even more stringent than
14 price control, is the way I would put it.

15 Q Perhaps I can put it crudely. Is your view that there is not flexibility because if you price
16 trunk according to DSAC and you add to that the price control we are terminating, add those
17 two together you have a problem, is that your position?

18 A It is not a question of adding them together the price control in terminating is a fact, it is a
19 fact of the contextual situation which properly has to be taken into account when evaluating
20 the cost orientation obligation in trunk. So it is simply, again I say to you, normal
21 economics, what are the facts of the case? That price control is given and we are not – you
22 were asking me earlier why we hadn’t gone into great detail in the price control document,
23 because we are not interested in the detail of that because we take that as given. The issues
24 are to do with given that, what does the cost orientation obligation mean? What is the
25 sensible interpretation of that condition, because the way in which that condition is
26 interpreted will affect pricing in the market and that will affect consumers, it will affect
27 competition it will affect efficiency, so the decision the Tribunal makes actually has real
28 effects, and it is necessary to evaluate these real effects, and those real effects can only be
29 evaluated in the factual context, and the factual context contains a price control. To neglect
30 it is to neglect relevant aspects of the factual context, that’s a major point of the report.

31 Q Absolutely, but I do not think we are disagreeing, and I am happy to say that we all agree
32 that the terminating price control is a given, we have all got to live with that, have we not?

33 A Yes.

1 Q Would you agree with me that one should not, as a Regulator, allow a regulated company to
2 undertake a step which will undermine the efficacy of that price control?

3 A Not the efficacy, no, because undermining the efficacy of that price control would mean
4 relaxing price constraints on terminating, that is the primary purpose of it, and you certainly
5 would not want that.

6 Q Professor Yarrow, I understand that there is not a dispute between yourself and Mr. Bolt in
7 relation to the use of DSAC. Your view is that it should be an initial screening test, is that
8 right?

9 A My strong view is that it can only sensibly be an initial screening test, because it is a
10 concept with no pedigree in economics, it is an arbitrary number. Can I just say, I think
11 there is a real problem here because Ofcom consistently refers to SAC and LRIC when they
12 mean DSAC and DLRIC, the two are entirely different concepts. What Ofcom says is you
13 are supposed to be able to infer from the particular context they are using a word, which it
14 is. It is by no means always clear which it is. So this DSAC thing, if I communicate one
15 thing to the Tribunal that I believe to be true it's that this is pretty arbitrary.

16 Q But I think everyone accepts that when one comes to allocating costs one can accuse many
17 different systems of being arbitrary, can one not?

18 A One can, and one can look at what Professor Hausman says at para. 46 again, if I can just ---
19 -

20 Q Paragraph 46 of what?

21 A The first report of Decker and Yarrow, that is at p.675. If the Tribunal do not know
22 Professor Hausman, he is probably the most distinguished telecoms economist globally; he
23 runs the MIT Telecoms Economics Research Programme, he has been awarded all sorts of
24 medals and is frighteningly clever. At para.46 we quote from Hausman because we think
25 this summarises the economics of the case.

26 Q Can I just ask you this – I do not want to stop you referring to that in due course – you
27 appear to accept in your statement that DSAC can be used as a screening test. All I want to
28 understand from you is what does it show after the screening? What does it show? What
29 can it be used as evidence of?

30 A What can be used as evidence?

31 Q You accept that DSAC can be used as a screening test?

32 A Yes, anything can be used as a screening test.

33 Q At the end of it – let us assume you have used it as a screening test and DSAC has been
34 failed?

1 A Yes.

2 Q What consequence does that have?

3 A You don't use DSAC. Presumably the question is, do these prices conform to the cost
4 orientation condition? If you find prices above DSAC, you have got the screening test.
5 You do the further investigation. Then, as a result of that investigation, if you find that the
6 prices are cost orientated then that's it, that's the conclusion.

7 Q Let me just stop you there. Let us take it in stages. Using your approach of it being a
8 screening test, let us assume that we apply DSAC to trunk segments. I agree that you do not
9 like using just trunk segments, but please go along with me. You apply DSAC to trunk
10 segments. DSAC is very substantially exceeded.

11 A Yes.

12 Q You then go on and have a look at rates of return for trunk segments. The rates of return
13 turn out to be huge?

14 A You could do that, or you could look at what the rates of return are on sales to consumers.

15 Q Let us just stick with trunk segments for the moment. Are those not very strong indicators
16 that there is a problem with prices?

17 A No, absolutely not.

18 Q If one is looking at trunk segments as being the relevant object of the exercise?

19 A Absolutely not.

20 Q Why not?

21 A Because you will find again, scattered through the history of competition cases, cases where
22 very high rates of return have been found to be quite compatible with competition.

23 Q So as far as you are concerned higher rates of return themselves are not an indicator. I
24 thought you had agreed with me earlier that high rates of return are an indicator of excessive
25 pricing?

26 A Not of excessive pricing, of flexibility, but again relative to not having those high rates of
27 return ----

28 Q I am still trying to ----

29 A -- particularly when you take very narrow segments. If you go back you will find lots of
30 cases – in fact, rates of return on capital used to not be used for certain categories of MMC
31 cases. I did one a long time ago, I think it was sugar trading, and the Commission there
32 took the view that these were totally unreliable indicators because once you got down to
33 small slivers of value added it became very difficult to attribute the capital in a way that was
34 meaningful. This is a danger warned against in telecoms by the European Regulators'

1 Group as well, and we have quoted that in the report. I have seen rates of return which have
2 been in hundreds of per cent, which have not been problematic, and indeed some go so high
3 that you go through infinity into negative numbers because strange things happen when you
4 take too, too narrow a price. That's why DSAC – the rational thing about DSAC, the good
5 thing about DSAC, is that it was based upon large increments. When you get to large
6 increments, when you are considering large pieces of economic activity, it is much easier to
7 get a sense of what the relevant measures are. As you narrow down it becomes more and
8 more difficult.

9 Q Can I please go back, Professor Yarrow, to initial screening. As I understand it, in your
10 report you accept that DSAC can be used as an initial screening test?

11 A It can be, yes.

12 Q What I am trying to understand is the significance that you give to a failure of DSAC if it is
13 an initial screening test. As I understand it ----

14 A On its own the significance of a failure of a screening test is that you go on to investigate
15 and do other assessments based principally on effects. You then get to it – Professor
16 Hausman, I think again explains the underlying economics of it.

17 Q The additional tests you do would, include, for example – this would not be a conclusive
18 matter – how much is the rate of return that is being earned on this product which has failed
19 the DSAC test? That would be a relevant question?

20 A No, because that begs the question of how it fits into the jigsaw. One of the issues, you see,
21 when you are working out rates of return is what allocation of common costs you are
22 placing against this product.

23 Q Perhaps I can cut it short. We are dealing just with trunk segments at the moment.

24 A Yes, but you must have a view as to what is an appropriate allocation of common costs – it
25 says under the condition that you have got to decide what is appropriately attributable.

26 Q As I understand the position, the one point which comes out clearly from your report is that
27 you are saying there is something wrong with this determination because it does not allow
28 BT to earn an appropriate rate of return.

29 A That is a big point on PPC ----

30 Q So clearly you consider the concept of rate of return to be vital in a setting of cost
31 orientation?

32 A When it's related to – in this particular case – the rate of return on supplying a relevant
33 customer group, the CPs.

34 Q We part company, it seems, when we come to looking at the rates of return on trunk.

1 A Yes.

2 Q Although there is a huge rate of return on trunk, you regard that as being irrelevant?

3 A It can't be interpreted on its own. It's impossible to interpret that. You cannot say that's a
4 high rate of return on such a narrow sliver of value added without actually looking at how
5 these trunk segments fit with everything else. We're dealing with a multi-product firm and
6 all of these things ultimately depending upon cost allocations among different products.
7 The cost allocation, again I am trying to get to Professor Hausman, the allocation of
8 common costs is arbitrary. There is a real element of arbitrariness that stops you saying – if
9 you say, is 74 per cent a high rate of return, I can't say, except that it's a higher rate of
10 return than 20 per cent, it's a higher rate than the return on the cost of capital, obviously, but
11 that's just numbers.

12 Q Let us put aside trunk segments or anything like that. As a matter of economics, what does
13 a first order test mean? This is completely on a theoretical level, please, for the moment.

14 A I've never met the term before. I've never met it until I came to this case, just as I've never
15 met DSAC before I came to this case.

16 Q So you have never come across anyone talking about what "first order" means?

17 A "First order" means in mathematics, and again it's explained in the maths, the first order
18 effect is usually the most important effect. If you're dealing with ---- Well, let me not get
19 into calculations. I don't think it would be terribly helpful. "First order" often has a
20 common every day meaning, as meaning that is the big effect. You can't mean it here
21 because at least if we take the guidelines seriously, it seems to me – and again, I absolutely
22 agree with Ofcom's guidelines. It says we will do this as a first test. If you interpret it that
23 way, the primary test or the principal test is to do with effects on consumers and
24 competition. That is an entirely sensible position which is entirely in line with what
25 everybody else does. To make DSAC determinative or presumptive or whatever is out of
26 line with regulatory practice elsewhere. It's a simple fact.

27 Q In your report you suggest that when the words "first order" are used by Ofcom or rather by
28 the original regulator in the guidelines, it must be meaning first in time, rather than being
29 "first order" in the sense you have described – is that correct?

30 A I was trying to put an interpretation on the guidelines, which was the way I read them when
31 I first saw them. That's the reading of somebody who is very experienced in regulation,
32 what a sensible meaning of these terms would be. I interpreted it basically as it's a bit more
33 than first in time, because it is trying to do something. It's trying to tell you, "If you're
34 below this it's probably okay, it's probably a safe harbour, you probably shouldn't be

1 investigating; if it's above this, well, it doesn't say you necessarily have to investigate, but
2 it's telling you that in this area there may be one or two things you should perhaps look at
3 it". It's a bit more than doing it first, it's giving you a steer as to whether – a kind of first
4 indicator of whether there might be a problem or not. That's again a very common way of
5 doing things.

6 Q Would you agree with me that in the sense that they are used in the 2001 Guidelines – and
7 perhaps I can show them to you so that we are not guessing at what is said. Can you go to
8 bundle BT3, divider 12.2. You recall these Guidelines. I think you quote them in your
9 statement. If you, please, go to p.26, to the annex where we have the detail of a calculation
10 of DSAC and DLRIC, B1:

11 "In general, Oftel would consider a good first order test of whether a charge is
12 unreasonable or otherwise anti-competitive to be whether the charge in question
13 falls within a floor of long run incremental cost and a ceiling of stand-alone cost."

14 If we stop there for a second, would you agree with me that, as a matter of language, when
15 one refers to a "good first order test" of a charge being unreasonable or anti-competitive it is
16 referring there to first order in the traditional sense of something which is of a higher order
17 of importance?

18 A No, I think you can have good screening tests and bad screening tests. The major problem
19 with language there is that it is assuming a stand alone cost, and if Ofcom did that, actually
20 had a ceiling of stand alone costs we wouldn't be here.

21 Q With respect, Professor Yarrow, please, can I read the next sentence:

22 "Oftel explains its methodology for deriving floors and ceilings ..."

23 A Exactly.

24 Q Let me just finish, please, and put the question. Do not try and guess what I am asking you.
25 It is absolutely clear, when one looks at this annex and the specific reference to
26 methodology, that Oftel here are referring to DSAC and DLRIC?

27 A Why do they not say so at the first sign?

28 Q Have you read this document?

29 A They consistently do this, and it does say it later on, but why doesn't it ----

30 Q So what is your point?

31 A The point is that these are two different creatures. This is a cat and a dog. SAC doesn't
32 distribute costs. DSAC does. DSAC therefore introduces a whole element of arbitrariness
33 to do with allocation, which I don't think any of the economic evidence will contradict.

1 This is a cat and a dog. Why not call a cat a cat, and a dog a dog? Why does Ofcom here
2 say “stand alone costs”, as they consistently do, not just here but throughout documents?

3 Q With respect, Professor Yarrow, you are not reading the very next sentence:
4 “Ofcom explains its methodology for deriving floors and ceilings in paragraphs B3-
5 B5 ...”

6 A You’re not ----

7 Q Let me finish, please. When one goes to look at those paragraphs, would you agree with me
8 that ceiling and floor are DLRIC and DSAC?

9 A When you’ve read the appendix, when you’ve gone through it ----

10 Q Let me just finish ----

11 A Let me say something, because, you know, I’m here as an expert, but I’m also here as an ex-
12 regulator. This is incredibly bad regulatory practice. That’s why I’m getting a little bit
13 agitated. Where you’re saying “SAC” and you mean “DSAC”, what is the cost of being
14 precise and clear to everybody in the world by putting the “D” in front and telling them that
15 it’s a cat and not a dog?

16 Q Because one can go just two pages ahead ----

17 A But why does one need to go two pages ahead?

18 Q Let me finish.

19 THE CHAIRMAN: Professor Yarrow, I think it is best to treat this as a tennis match with
20 Mr. Saini asking the questions and you answering them.

21 A I do apologise.

22 MR. SAINI: Two pages ahead, go ahead to the very pages you are asked to look at, please look at
23 B15, p.31. B15 describes the ceiling and floors as distributed incremental cost floors and
24 distributed stand alone costs. It is not because Ofcom want to use those words, but because
25 those are the words that BT itself uses for the ceilings and floors. Have you read that, B15,
26 Professor Yarrow?

27 A I would put a lesser obligation on a private company than a public authority to be precise ---
28 -

29 Q Have you read B15? Have you read B 15?

30 A B15?

31 MR. READ: My learned friend must let the witness finish his answers before he continues with
32 the next question because otherwise we are going to end up with the tennis match not being
33 fair.

34 MR. SAINI: My question is, have you read B15?

1 A I have read B15.

2 Q Have you read it before?

3 A I've read it before, I've read this whole bit.

4 Q Do you accept that reading this annex, it is absolutely clear that the ceilings and floors are,
5 as described by BT, DLRIC and DSAC?

6 A It is clear. I wouldn't say it was absolutely clear because if it had been absolutely clear they
7 would have called it DSAC when it was first mentioned. That causes an element of doubt.
8 It certainly confused me when I first read all of this. I'm sure it would confuse people who
9 were much less familiar with these concepts. Again, if we have a concept like SAC, stand
10 alone cost, which comes out of economic theory, widely used, it's part of the common
11 language, I would say it's very bad regulatory practice to use that when you mean
12 something else. Ofcom have consistently done that. I think it causes confusion. I'm sorry
13 to have raised it and we'll perhaps go back more to the economics. But the economic point
14 is that these are very different concepts. These are cats and dogs, and I simply make the
15 point call a cat a cat and a dog a dog the first time you mention it. It would be very easy for
16 Ofcom to be precise on these things.

17 Q We are obviously not going to agree as to whether or not they were precise. Let us put that
18 away, please. May I go back to your report, please, your first report. Before I ask you to
19 turn to a particular paragraph in relation to that report, would you agree with me that the
20 most important combinatorial test to be undertaken when assessing a cost orientation
21 obligation are combinatorials amongst the services which share the most common costs
22 with 2 Mbit trunk?

23 A I think it would be one aspect of it. I mean, the other is to look at the demand side and what
24 consumers are buying. So most of these things are not settled in abstract. I think when you
25 come to deciding what tests to run you would look at the factual context and see what
26 economic linkages there were both on the demand side and on the cost side. Certainly, the
27 fact that if two services do share a lot of common costs that are not shared with others, then
28 that would be a natural combination to consider.

29 Q Would you agree with me that when undertaking combinatorials for trunk segments it is
30 important to undertake those combinatorials with services that share common costs for
31 trunk segments? I think you agree with that, but I may have misunderstood you.

32 A I'm not a fan of combinatorial tests, you see.

33 Q I do not want to talk about whether you are a fan of it. I just want to know whether or not
34 you agree. We are going to let you say whatever you like about combinatorial tests.

1 A But you are asking me whether it's good to do it this way and the fact is whether it's good
2 to do it that way depends upon the factual context. In this particular factual context what I
3 think I'm saying is the Tribunal can safely settle the issues without getting too much into
4 those segments.

5 Q Is it your view that combinatorial is a bit of a waste of time?

6 A On the whole probably yes. I think it probably was a distraction in this case. It depends
7 what methodology you're using. My preference would be to ask a simple question about
8 what the costs are of supplying the customers concerned and what they're paying. That
9 doesn't involve SACs or anything; it doesn't involve any of the stand alone cost arguments,
10 these DLRIC arguments or anything like that. If you get into combinatorials which,
11 originally in this area, came out of contestability theory but they don't depend on that, it's
12 another way of thinking about things. It's looking at individual combinations. If you're
13 going to do it then you should do it well obviously. If all you're asking me is if you've
14 determined that you're going to do this thing, then certainly you should look and give some
15 priority to combinations of shared costs.

16 Q Thank you very much. I do not know if this is a matter of dispute (it may not be) but do
17 you agree that one of the big problems of the combinatorial tests in the present context is
18 that where they have failed it is very hard to identify which service has caused the failure?

19 A If they've failed, they've failed. They are combinatorial tests, so that's what they do.

20 Q You do not know who has caused the failure.

21 A Because it's a meaningless question in a sense. You're looking at the combination; they fail
22 in combination. It's a common problem in social sciences when you're testing a hypothesis.
23 You test a joint hypothesis. If you failed you don't know which bit was necessarily wrong.
24 We live with these things all the time.

25 Q I am sorry, I asked you to go to your report. I was going to go to a particular part of it.
26 Would you go, please Professor Yarrow, to your conclusions which are at p.708. There are
27 four bullet points in which you helpfully set out your conclusions, you will recall that?

28 A Yes.

29 Q The first one is a complaint about whether or not the guidelines were treated as
30 determinative. Obviously, the Tribunal will have to decide on the evidence whether or not
31 that is what Ofcom did. Please do read the last three bullet points before I ask my question.
32 (Pause.

33 A Yes.

34 Q Tell me when you have finished.

1 A I have finished.

2 Q As I understand it, the conclusions in those last three bullet points are all premised on your
3 expert view that in assessing cost orientation in relation to condition H3 Ofcom should have
4 aggregated trunk and terminating segments. Is that right?

5 A No, Ofcom should have made the assessment of the relationship between price and the
6 recorded cost in the accounts, which depend upon the particular cost allocation. They
7 should have looked at that in its context, taking account of a number of other factors, one of
8 which is that the customers buy jointly, and another is that therefore there is a natural
9 linkage to terminating segments.

10 Q Can we just take them in turn, then, because I am not sure we agree on this and I did not
11 think it was a matter of dispute. I do not see what the dispute is. The second bullet point, if
12 you would read it, your complaint there is one about lack of latitude in pricing and also
13 failing to get a normal rate of return. As I understand it, that is all premised on the basis
14 that you are looking at PPC services rather than trunk?

15 A No, you're looking at trunk, but you're looking at the effects of a particular interpretation of
16 cost orientation in trunk and that particular interpretation has the effect of not allowing you
17 to make a rate of return on trunk and terminating combined.

18 Q So we are agreed, I think, that the relevant question that you are posing and saying that
19 causes a problem in your second bullet point is that when you look at trunk and terminating
20 combined your point is that that fails to allow a normal rate of return?

21 A That's the conclusion, yes.

22 Q That is what I understood. The third point, it seems to me, just simply follows from that.
23 You say in the third bullet point it is a consequence that there is a serious risk to consumers.

24 A That's right.

25 Q The fourth point is the complaint that Ofcom has required the cost orientation condition to
26 be applied to each and every service because it has defined separate markets. You do not
27 agree with that, do you?

28 A There's no problem with the "each and every", it's required to consider each and every. It
29 is what information and evidence it takes into account. So that the objection is that it does
30 that without assessing the wider relationships. That is the objection.

31 Q This may not be a matter of dispute but it seems to be the common theme running through
32 both of your reports is that Ofcom was obliged, as a matter of appropriate regulation, to
33 combine trunk and terminating charges when assessing cost orientation of trunk charges. Is
34 that a fair summary?

1 A Well, it follows indirectly from something that is true. Ofcom was obliged, under what it
2 said, what it gave as its own guidelines, that a primary and principal focus would be on the
3 effects of its decision. It was obliged to evaluate the effects of this decision. One of the
4 effects is to mandate a level of return on PPCs as a whole which is less than the cost of
5 capital, which is pretty close to the original sin in regulation. That is an effect which then
6 goes on, and as you rightly said, as bullet point three said, it is the failure to take account of
7 relevant information. I think what I'm saying in terms of the economics is that this
8 assessment proceeds in a way which strips the question from its context, which is a very
9 specific factual context, and turns it into a kind of abstract exercise about the relationship of
10 some number price which is a real number because people pay that, and another number,
11 cost, which is an arbitrary number because it depends upon cost allocation decisions which
12 are ultimately arbitrary. That price cost comparison on its own tells you nothing. As I say,
13 in this particular case, if the effect is to treat DSAC as the maximum, the effect is to stop a
14 normal rate of return being allowed, and that has negative consequences. Ironically, Ofcom
15 itself agrees with this. This is where I keep coming back, and I refer again the Tribunal, to
16 the 2009 charge control, paragraph 4.183 - 183 of Chapter 4. Ofcom says that unless it
17 allows BT to put up its prices of terminating it won't be able to get a normal rate of return
18 on terminating and trunk combined. This is the new price control. That is treated as a
19 serious problem, because Ofcom allows BT to put the prices up immediately. The reason it
20 says we've got to allow the immediate price increase is because if we don't do this BT will
21 not be able to earn a normal rate of return, it won't cover its costs of capital on trunk and
22 terminating combined. That's Ofcom. That's my position as well.

23 Q I do not want to go to the 2009 report because this is not before the Tribunal and it is not the
24 subject of any additional report. But is it not the case that after the 2008 BCMR review,
25 which it seems you did read, a specific price control was introduced for trunk segments?

26 A Yes.

27 Q Thank you very much.

28 Cross-examined by Miss ROSE

29 Q Professor Yarrow, can you take up bundle ADB2 please. I think you said in your evidence
30 this afternoon that in 2004 it was your understanding that Ofcom had made a conscious
31 decision that it would only permit to BT a very low rate of return on terminating segments.
32 Was that your evidence?

33 A Limited recovery of common costs.

34 Q You said that was a conscious decision by Ofcom?

1 Q Can you please turn to tab 4 in this bundle. This is the Partial Private Circuits Charge
2 Control final statement. This is the statement that set the charge control for terminating
3 segments. Are you familiar with this document?

4 A I know of it, but I have not read it. I am not going to claim familiarity with any of these
5 documents.

6 Q Are you aware that this was the document that set the level of the charge control for BT for
7 terminating segments?

8 A Yes.

9 Q Are you aware that in the course of the consultation that led to this document, BT made the
10 submission to Ofcom that the proposed charge control for terminating segments was too
11 low?

12 A Yes.

13 Q Because it did not permit a sufficient return on costs?

14 A Yes.

15 Q Are you aware that that submission was rejected by Ofcom?

16 A Yes.

17 Q Are you aware of the reasons why?

18 A I am not aware of the reason Ofcom gave. I took it to be a judgment of a regulator that they
19 were following the policy which they discuss in other documents of where there is, let us
20 put it this way, a strong monopoly position as there is in terminating segments where there
21 aren't any alternatives, they would lean towards low levels of common cost recovery from
22 those particular type of services.

23 Q So it is your understanding, is it, that Ofcom made a conscious decision not to permit BT to
24 recover its costs on terminating segments? Is that your understanding of Ofcom's policy?

25 A There is no such thing as costs, you see. There is a bundle of costs which can be allocated.
26 The decision that Ofcom makes is that a certain level of those costs can be recovered from
27 the terminating segments. So out of this pool of costs it's taking apart and saying, "We will
28 set a price which enables you to recover this amount" and it is a rather small amount, and
29 again you will know that in this recent price control that amount has been increased by
30 about £55 million, so it makes a conscious decision as to how much, where there is a price
31 control, and then by implication since these common costs are shared among products
32 which are price controlled and obviously products which are not, then by implication the
33 things must add up. It implies larger or different amounts of common costs. They are not
34 allowed to because in those other sectors BT is supposed to be subject to more competition

1 so they are treating it as reasonable larger amounts of common costs should be recovered
2 from those other de-controlled services.

3 Q Can you please turn to p.105 in this document? You see the heading: “BT’s PPC
4 profitability analysis”?

5 A Yes.

6 Q Paragraph C.28:

7 “In addition to review BT’s Pricing Model, Ofcom has considered whether there is
8 any evidence that current PPC terminating segments charges either are or have
9 been too low such that BT had not been fully recovering costs.”

10 Do you see that?

11 A Yes.

12 Q That is specifically the issue they are addressing?

13 A But there, you see, can I make a plea again for precision, because what they mean here is
14 LRIC, not recovering long run incremental costs.

15 Q Do you think this means LRIC?

16 A Yes, or DLRIC maybe.

17 Q Without considering return on capital?

18 A Yes, because exactly what Ofcom have stated, they will go closer to DLRIC where we are
19 dealing with relatively monopolistic areas.

20 Q Well let us just read on the rest of the paragraph before you commit yourself to that.

21 “At face value the outputs of BT’s Pricing Model would appear to suggest that this
22 is the case. Ofcom considers this will be reflected in BT’s rate of return.”

23 Do you see that? They are looking at BT’s rate of return, are they not?

24 A Yes.

25 Q “BT provided a financial schedule for 2002/03 in a form that disclosed the
26 profitability of each individual regulated PPC terminating segments service, rather
27 than these being reflected within overall totals for revenues, costs and mean
28 capital employed for the inland private circuit network component.

29 According to this profitability analysis BT disclosed a return on mean capital
30 employed of 39%, 10 % and 17 % for [the three years in question]. It should be
31 noted these figures include the results for trunk transmission, which is not subject
32 to the proposed PPC terminating segments charge control. As discussed above the
33 reported volumes split between trunk and distribution proved inconsistent with the
34 costs. In the absence of a reliable volume split and recalculation of the transfer

1 charge revenues from BT's downstream activities results for trunk transmission
2 has been included in the overall profitability analysis."

3 What Ofcom are saying there, are they not, is that BT has provided an overall indication of
4 its profitability on PPCs, including trunk?

5 A These are not PPCs, again there is a lack of precision. I am not sure whether this is ----

6 Q Well it says: "These figures include the results for trunk transmission" do you see that?

7 A Yes, but when it talks about BT's profitability it does not actually specify which activities, I
8 think I would need time to read back to see what it is referring to.

9 Q Well, let us just look at it. It certainly includes trunk as well as termination?

10 A It does, it certainly does that but it might ----

11 Q And the point that Ofcom is making is that they were unable, from the figures that were
12 provided to them by BT to split out the return on capital for trunk, and the return on capital
13 for terminating segments, that is the point they are making, is it not?

14 A Yes.

15 Q Then they say this at 31:

16 "Based on the above profitability information available, Ofcom concludes that
17 there is insufficient evidence to suggest that BP is substantially under recovering
18 its costs in terms of supplying PPC terminating segment services to its
19 downstream operations and to the Altnets combined over a sustained period."

20 Do you see that?

21 A Yes, and again I say my interpretation of that is that is referring to one of the two measures
22 of incremental costs, which is where the complaints were, but we do not know because of
23 the lack of precision in the statement here.

24 Q Well they are addressing BT's profitability analysis and they are saying BT put this to us,
25 but unfortunately we could not split out the terminating from the trunk so there was
26 insufficient evidence to conclude they were under recovering on termination, that is what
27 Ofcom are saying, is it not?

28 A Well it is under recovering relative to what? If you look at the regulatory accounts, and
29 again it is fairly transparent – there have been changes through time and you need to talk to
30 BT because they are the experts and the accounts and Ofcom they will know them better
31 than I do – I understood that there have been changes in the accounting systems, but the
32 accounts I looked at actually set out all these charges which give DLRICs and DSACs and
33 all the rest of it. What you find there is in terminating that there were a number of charges
34 below DLRIC. In other words, there were charges in that period below the price floors.

1 BT, as I understand it but I may be wrong, you can ask BT what they were arguing, my
2 understanding was that BT was going and saying: “Look, this is crazy because you are
3 actually mandating ...” and this is a price control, remember, in terminating “... you are
4 mandating prices below, in some cases, DLRICs. We would like these up, please.”

5 Q You understand, do you not, that as at 2004, the view of Ofcom was that BT was not a
6 relatively efficient operator?

7 A I am not aware that that was Ofcom’s view at the time.

8 Q And the price control level will be set at a level to incentivise a company to improve its
9 cost efficiencies, will it not?

10 A I do, but I understand that there have been efficiency studies, two studies at least one of
11 which puts BT in the top decile, so ----

12 Q We are looking at 2004 here?

13 A Yes, well if you can direct me ----

14 Q You are not suggesting that that is the position in 2004, are you?

15 A I don’t know. If you can direct my attention – you asked me about Ofcom’s belief, if you
16 can point me to a statement in here which sets out Ofcom’s belief that BT was inefficient in
17 2004 then I accept it obviously.

18 Q We will find that for you in a moment, Professor, but let us just stick on this page here. We
19 see the conclusion at C.33, p.106. At C.32 Ofcom says:

20 “[It] needs to be satisfied that in making decisions affecting cost-orientated prices
21 it has available robust and reliable data. Given the uncertainties and concerns with
22 BT’s pricing model as explained above, a preference for the gradual realignment
23 of relative prices if so required, and profitability information which questions the
24 justification of increased prices, Ofcom cannot currently endorse BT’s model or
25 its outputs.

26 Ofcom therefore has decided to use current charges as the starting charges for the
27 PPC charge control in the absence of persuasive evidence from BT on the
28 robustness of model and evidence demonstrating that BT is under recovering costs
29 in its controlled PPC terminating segments charges.”

30 Now there was no conscious decision by Ofcom, was there, that BT should not be able to
31 recover its costs?

32 A Well there again it depends on what “costs” mean. We need precision. “Costs” can be
33 anything, DLRIC, LRIC, SAC, DSAC, which costs? My understanding is that the main
34 controversy is that certain prices at the time were very low in relation to the price floors for

1 DLRICs, and that is the cost that BT were complaining about. I'm not aware that BT have
2 any abstract notion of costs that it was trying to recover. My interpretation, my
3 understanding, and again you can ask the people who will know, my understanding is that
4 the issues were to do with the fact that we had a price control which was mandating prices
5 below a DLRIC price floor, which is again a rather serious ----

6 Q Ofcom says at the paragraph we have just been looking at, that BT had failed to persuade it
7 that they were under recovering costs, is that not right?

8 A That's right, and that was the basis of the decision, and let's make it clear I am not
9 challenging the decision. I may well have been there and actually recommended that
10 decision, because sometimes in price controls you take tough decisions and say to BT:
11 "You can appeal if you think it is too tough", you can ----

12 Q Did BT appeal?

13 A No, so BT swallowed it, so there is no argument about the decision, the issue is what costs
14 are we talking about? What costs are we talking about.

15 Q Just pausing for a moment, the PPC charge control did not just apply to terminating
16 segments, did it?

17 A No.

18 Q It applied to a basket?

19 A Yes.

20 Q And the RPI minus X formula was applied to all the costs in the basket, all the charges in
21 the basket?

22 A Yes.

23 Q You asked for the reference in relation to efficiency, if you go in the same document back to
24 p.5 you see the heading: "Efficiency studies", do you see para. S.17?

25 A Yes.

26 Q The conclusion of NERA is that:

27 "BT is in the region of 9% to 10% inefficient in its provision of services over its
28 network as a whole relative to the top performing decile of the US LECs."

29 Do you see that?

30 A Yes.

31 Q They then discuss:

32 "It is reasonable to expect inefficiency existing at the start of the charge control
33 period to be eliminated over the life of the four year control, just as competitive
34 pressure would force companies to become efficient in a competitive market. The

1 underlying rate of cost reduction over the period of the charge control is therefore
2 adjusted to reflect the anticipated reduction in inefficiency.”

3 Do you see that?

4 A Yes. They are trying to drive BT to the frontier ----

5 Q Yes.

6 A -- but that is 9 to 10 per cent compared to the top performing decile, which is an
7 international comparison, and I might remind the Tribunal which we have been warned
8 against. But yes, I think in every price control you will anticipate, even if the company is
9 efficient at the particular time, perfect efficiency is rather an abstract concept anyway, but
10 you would normally expect that over a period of four or five years, that a company will be
11 driving extra efficiencies, and therefore you will be imposing an X factor to reflect that.
12 They are not saying that BT is particularly inefficient in comparison with the top
13 performing firms.

14 MISS ROSE: Sir, I am about to move on to a different topic so that might be a convenient
15 moment.

16 THE CHAIRMAN: Now might be a good time. Mr. Yarrow, I am sure you have been told,
17 but -----

18 A Talk to nobody.

19 THE CHAIRMAN: Exactly. Thank you.

20 (Adjourned 10.00 a.m. on Tuesday, 26th October 2010)