IN THE COMPETITION APPEAL TRIBUNAL

Case Nos. 1275/1/12/17
1276/1/12/17

Victoria House,
Bloomsbury Place,
London WC1A 2EB

13th November 2017

Before:

PETER FREEMAN CBE QC (Hon)
(Chairman)
PAUL LOMAS
PROFESSOR MICHAEL WATERSON

(Sitting as a Tribunal in England and Wales)

BETWEEN:

FLYNN PHARMA LTD AND FLYNN PHARMA (HOLDINGS) LTD Appellant

- and -

COMPETITION AND MARKETS AUTHORITY Respondent

- and -

PFIZER INC. AND PFIZER LIMITED Appellant

- and -

COMPETITION AND MARKETS AUTHORITY Respondent

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HEARING – Day 8

A P P E A R AN C E S

Kelyn Bacon QC, Ronit Kreisberger and Tom Pascoe (instructed by Macfarlanes LLP)

Mark Brealey QC, Robert O'Donoghue QC and Tim Johnston (instructed by Clifford Chance LLP)

Mark Hoskins QC, David Bailey, Hugo Leith and Jennifer MacLeod (instructed by CMA)

Monday, 13 November 2017

(10.30 am)

THE CHAIRMAN: Good morning. Any reflections over the weekend?

MS BACON: Good morning. Yes, we have reflected. We have I think one thing to hand up. There have been a couple of additions to the bundles, which I do not think I need to trouble you with. There is a letter that has gone to the tribunal this morning.

During the course of preparing for the cross-examination of Mr Harman, I queried one figure in one of the appendices to Mr Williams' second report and unravelling that led to us discovering there were a few typographical errors, and they really are typos. For example, a number has been transcribed wrongly in a number of cases.

THE CHAIRMAN: You can change a lot with a typo.

MS BACON: Yes. As it happens it changes in our favour, if anything. What we have done is to set that out in a letter to the tribunal and we have done a revised version of the appendix 3. I will hand that up now. My learned friend obviously has not had a chance to look at it, so what I would propose is if he has anything he wants to say about it, or indeed if Mr Harman wants to say something about it, they can do so tomorrow morning, and we will start off with that then.

THE CHAIRMAN: (Handed) So be it.

MS BACON: Mr Brealey wants to make a different point.

MR BREALEY: It is a small point but not an unimportant point.

THE CHAIRMAN: I would not imagine you would make an unimportant point, Mr Brealey.

MR BREALEY: I should draw the tribunal's attention to the fact that the head of the CMA, Mr Coscelli, gave an interview on Friday, which was clearly intended to be reported, which comments on the ongoing case. This was in the MLex article. I do not know whether the tribunal saw it?

THE CHAIRMAN: I try not to read anything like that.

MR BREALEY: I will not say much more about it, but in my respectful submission it was quite inappropriate. It does comment on the ongoing case, it talks about the implications of the evidence-gathering exercise, and if the tribunal has not read it I would ask the tribunal not to read it, because it appeared to us, and quite genuinely I believe, to be an unsubtle attempt to put subtle pressure on the tribunal, and I would ask in this forum that the CMA try not to give interviews to the press commenting on the current evidence and state of play of the appeal.

As the tribunal may know, the Attorney General in September of this year launched an inquiry into the extent to which social media should comment on ongoing criminal trials, so it is not a minor matter. The fundamental point is the tribunal should hear the evidence and submissions in this tribunal, in this forum, and the CMA should not be making submissions outside the forum trying to influence the tribunal.

I say no more about it if the tribunal has not read it, but I felt I should put a marker down because again, in my respectful submission, it was quite inappropriate to conduct such an interview which was obviously going to be reported.

THE CHAIRMAN: Mr Hoskins, do you have anything to say?

MR HOSKINS: I know nothing about the article either so I do not have anything to say, and I have no instructions on it, it is the first time I have heard about it. But if you need me --

THE CHAIRMAN: If you do obtain instructions and have anything to tell us, then perhaps you would in the course of the remaining part of the hearing.

I have to say, we are not approaching this case in any kind of political regulatory context, we are simpling hearing the evidence and we will decide the case on the evidence. We cannot do any more than give you that assurance. As a matter of fact, I have not myself either been aware of or read that.

MR BREALEY: I know MLex does get disseminated quite widely in the competition sphere. I say no more, it is just that we did find it quite inappropriate.

THE CHAIRMAN: Right. Are we now free to proceed?

MR HOSKINS: I call Mr Harman, then, please.

MR GREG HARMAN (sworn)

THE CHAIRMAN: Please take a seat, Mr Harman. Your counsel will put some points to you, I think.

Examination-in-chief by MR HOSKINS

MR HOSKINS: Could you be give bundle F, please. At tab 1 is a document, "Report of Greg Harman"?

A. Yes.

Q. Can you just flick through the pages to the signature page which is the very last one and confirm that that is your first report?

A. Yes, it is.

Q. And that is your signature?

A. It is indeed.

Q. Then tab 3 of this bundle, "Supplementary Report of Greg Harman"?

A. Yes.

Q. Just do the same, please look through the pages, and the signature this time is on page 55?

A. Yes.
Q. Please could you confirm that that is your supplementary report?
A. It is.
Q. And can you confirm that is your signature?
A. It is.
Q. Then tab 5, can you confirm that is a joint statement you made with Mr Williams?
A. It is.
Q. Can you confirm that the facts set out in these documents are true to the best of your information, knowledge and belief?
A. Indeed.
Q. Can you confirm --
A. Caveating the one point that apparently there is an error somewhere but I obviously do not know what that error is.
Q. Is there something you want to say about that?
A. No, I thought I heard Ms Bacon saying --
MS BACON: That was in Mr Williams'.
A. My apologies, then yes.
THE CHAIRMAN: You take more burdens on yourself than you need to.
MR HOSKINS: And can you confirm that the views set out in these documents represent your independent expert

opinion?
A. They do.
MR HOSKINS: There will be some questions.

Cross-examination by MS BACON

MS BACON: Sir, just to explain how I propose to structure the cross-examination to assist you and Mr Harman. I am going to broadly follow the structure of our skeleton argument, so I am going to start with some general questions, I am then going to look at the ROS benchmark followed by cost allocation, before finishing up with some questions about gross profit and product contribution measures.

If it would assist the tribunal, because I know there is quite a lot of ground to cover, I could pause at the end of each big section to allow time for the tribunal's questions or we could leave it all to the end.
THE CHAIRMAN: I think we will do questions as we go along.
MS BACON: I am aiming not to go into camera. I have gone through my notes and I have tried to ensure nothing I am saying is confidential, and I have confirmation from behind me that that is the case. We will obviously need to try and ensure that no one else reads out a confidential figure, so I will remind Mr Harman at appropriate times when we are looking at confidential material.

There is a lot of ground to cover, we are going to go into tomorrow. In fact I anticipate that between me and Mr Brealey we are going to need the full two days. If it looks as if I am making very good progress by mid-afternoon, and mindful that it is going to be a long two days for the witness, I might, with the tribunal's permission, suggest we rise early, but we might not have that luxury depending on how far I have got through my notes.

THE CHAIRMAN: I think we will take it as it comes.

MS BACON: Thank you.

So can I start with some general questions, Mr Harman, about the scope of your instructions. Could you take up your reports. Just to say, I am going to refer almost exclusively to your evidence and bundle D which has the evidence of the Flynn witnesses. So if you could have those two open in front of you the whole time, do not put either of them away. Occasionally I am going to need to look at something else but only a couple of time.

So could you turn to your first report and look at paragraph 2.1. You set out here the scope of your instructions from the CMA. You say that they asked you to consider two issues, one, cost allocation and, two, the reasonable rate of return.

Is it correct to say that both of those related to the CMA's cost plus or ROS analysis?

A. Yes, that is correct.

Q. Just flicking back a page, you explain at paragraph 1.14 that your instructions were not to consider from first principles how the CMA should approach the excessive price for this product, or indeed any product. So am I correct in thinking that the CMA did not ask you to consider from first principles whether doing a cost plus or ROS analysis was the right way to measure excessive price, but rather what it asked you to do was to give your opinion on these two specific disputed points in their analysis?

A. That is correct.

Q. So if you go back to 2.10 in your report, and you are talking here about the reasonable rate of return. In that paragraph you break the point down into two separate questions. So firstly, whether it is appropriate to use the ROS measure to determine a reasonable rate of return, and secondly, whether the 6 per cent benchmark was reasonable.

Just looking at the first of those two points, so whether it is appropriate to use the ROS measure to determine a reasonable rate of return, I just wanted to ask you some questions about how you did that

conceptually.
A. Yes.
Q. For the purpose of this exercise and that particular question, did you do any research into the generic pharmaceutical industry to see how companies measure profitability typically and what their normal rates of profitability are?
A. No, no, I did not. If I can just caveat what I did --
Q. I was going to ask you about what you did. Can I come to that? So can I take you to what you have done, because you set it out in your report, to see if I correctly understood it. Could you look at the next paragraph, 2.11 and 2.12. That seemed to me to be your conceptual framework, and you say there that ROS is a function of the level of investment, the level of risk and the level of revenue, and you ask in each case what the required ROS is from an investor perspective. Is that a summary of your conceptual framework?
A. Yes. Just to give it its full context, there is a very well-established theory for setting a required rate of return in competition analysis, in valuation practice and within competition analysis, and that is normally applied to industries that have a big capital base, and that is the weight of average cost of capital multiplied by the amount of investment, and that kind of principle

is fundamental to finance theory and it permeates pretty much everything we do in terms of regulation, valuation and assessments of reasonable returns in competition assessments.

The problem with this case is that it is an asset-light industry and that formulation may not be appropriate. I say "may" because in certain circumstances it still may be appropriate. So one has to derive from first principles how do you come up with a benchmark? And there is a clear theoretical link between the approach that I have just said and a rate of return on sales approach.

That basic formulation permeates pretty much everything that I do. I go back to that basic formulation and say for an industry, or for a product like Phenytoin for Pfizer and for Flynn, how does a reasonable rate of return stack up against that conceptual framework?

Q. Thank you. And I was just going to take you to where you explain that in more detail in your report. The section is then at 4.5 onwards which is headed "Conceptual Framework". So this is where you explain the point you have just made to the tribunal in more detail. You have looked at the ROCE and WACC analysis, I will come back to that, so I am going to look at that

during the course of I hope this morning. But if you go to 4.13.
A. Yes.
Q. You say that a ROS benchmark is anchored in the same conceptual framework as the ROCE methodology, so companies are compensated for the risk associated with the investments they make. So would it be right to summarise very shortly what you have done in this way: in order to answer the first of the questions that you put in paragraph 2.10, as an economist you have looked at what a ROS measure does conceptually and you have tested that against your conceptual framework that you have set out?
A. Correct. I basically conclude that a ROS framework can be manipulated into a conceptual framework that has economic meaning.
Q. Looking at your paragraph 4.13, you say:
"The right conceptual framework in this case is to look at the level of return that is required for the risk and investment that is present for Phenytoin."
A. Correct.
Q. And you have just explained to the tribunal, and you say in paragraph 4.15, that this is the fundamental basis of your assessment in this case. So am I right in

summarising it this way: your approach to looking at whether the ROS measure used by the CMA was reasonable was to ask whether it was to a level that you, as an economist or finance theorist, considered to be required in light of the level of risk and investment for Phenytoin?

A. Yes. Let me just step back, just to give that some context. The starting place goes to what is a reasonable return and that is a reasonable question. The OFT some time ago indicated that a reasonable return for a competition assessment is what you would expect in a normally competitive market, not a perfectly competitive market but a competitive marketplace, and they conclude that the weighted average cost of capital is an appropriate methodology to calculate a return for the first step of United Brands. So I have incorporated that into a framework.

I think that on page 39 at 4.12, the formula at D, I basically say that the return on sales as a percentage is equivalent to a reasonable return by reference to "the cost of capital", multiplied by capital employed, ie the level of investment, and your revenue. And three things come out of that which I think are important, and this holds true for any industry, including pharmaceuticals. There are some general tenets, if you like. The higher the risk, the higher your cost of capital, and therefore the higher your return on sales as a percentage needs to be. It just follows from this formula. The more investment that you make, it follows that you also will have a higher return on sales as a percentage. But also the higher the revenue, the lower the return on sales. And it is just this formula manipulated. And I think between the experts, where the common cause of that that is a sensible foundation or --

Q. I am not entirely sure that that is the case but we will look at that during the course of today.

Can you take up the decision and look at paragraphs 5.210 and 5.212.

A. Sorry, which ...?

Q. The decision.

A. Which is ...?

Q. Sorry?

A. I do not have that. (Handed)

Thank you. Which paragraphs?

Q. So paragraphs 5.210 and 5.212. On my copy it is at page 340.

A. Yes.

Q. Do you understand those paragraphs of the decision to be setting out the same framework as you have adopted?

A. Can I just read them?

Q. Yes.
A. Yes, basically it is saying that the level of return on sales is a function of risk, investment and, importantly, also the level of costs.
Q. Okay. You can put the decision away now. Standing back for a moment, do you agree that a completely different approach could have been to ask an empirical question such as: what is the rate of return that is normally made on a generic pharmaceutical product, or what is the rate of return that is normally made on a product like Phenytoin?
A. You mean that is a fair and reasonable question to ask. I think --
Q. I am just saying --
A. I am just trying to make sure my position is clear on it. Because as an economist, quite clearly you can either rely on theory or you can base yourself on empirical evidence. I think in reality those two should converge, it would be odd if the theory was telling you something completely different, and I have no reason to believe in this instance that they should not converge.
    I think the problem with looking at things empirically, as I have just stated, that to find a return on sales which is exactly comparable you need to make sure that they have the same level of risk, the

same level of investment and the same level of unit costs.

I am not putting that forward to be problematic, ie shooting holes in the other experts' evidence, I am saying that because it actually matters, it matters at a detailed level. When I look at the evidence from the generics I find there is a very wide dispersion of return on sales. If I looked empirically and I found everything pointing in the same direction, everything said 21 per cent no matter how I cut it, then I might be able to conclude that that would be a valid comparator, but it does not, and therefore I am concerned that using an empirical approach would be helpful, unless some context to each of those generics is provided, ie if a person said "I have looked at this comparator, I think it has the same level of risk, the same level of investment, and it has the same level of unit costs", then in those circumstances I would say that is a valid comparator.

Q. But you agree that, in principle, one could look at a reasonable rate of return by means of empirical observation and that would be a reasonable approach?

A. As an economist I would say yes, that is --

Q. And --

MR HOSKINS: Let him finish, please.

A. Oxera makes the same point in a document that is referred to by the CRA, but it makes the point very critically that you can use a return on sales approach by benchmarking so long as you control for the same cost structures and the level of risk. They do not just put that in as idle chit-chat, they put that in because it is of fundamental importance to the analysis.

So my general position would be that if that level of analysis has not been done, I can put little weight -- for myself, I would put little weight on that evidence because I just would not know if that was telling me something that is comparable. My concern is that you are comparing an apple and a kumquat as opposed to two apples.

MS BACON: So as I understand it, as you just explained, your analysis was a conceptual one rather than an empirical one?

A. I think that is fair.

Q. Another general point about your approach. We see that at various points in your reports you test your analysis by using cross-checks, and one example we will come to a bit later on is your ROCE cross-check which you say is to some extent informative about the 6 per cent.

In your role as an expert, would you accept that sometimes when you are carrying out an economic or an accounting analysis the analysis that you carry out will turn on parameters that are uncertain or imprecise?

A. I think I have one caveat -- not caveat to make, just one clarification to make. Firstly, you have said -- I would not want to necessarily say that all of the alternatives are cross-checks. The implication is that the PPRS is the main parameter, main benchmark --

Q. I was asking you a general question, Mr Harman. I am saying if you as an expert come across an analysis which turns on parameters that are imprecise, do you agree that that will sometimes happen?

A. That can sometimes happen. And I think what one has to do if you think that there is imprecision is you have to try to be generous in your calculations. So by reference to the return on capital employed, what I did there was I did the analysis by reference to all of the capital of Flynn, so it was not just Flynn's working capital, it was everything. But I was actually also generous in the calculation because I excluded creditors, and I also chose a higher weighted average cost of capital. So one way that you can deal with the imprecision is by flexing the assumptions in favour of the analysis.

Q. I was just going to come on to how you deal with it. So one way is to use generous assumptions, and do you agree

cross-checks would be another way do deal with that?
A. It depends on what the cross-checks are, but yes.
Q. I just want to explore the boundaries of the cross-checks that might be legitimate, and I do not think this will be controversial, I just want to establish what your approach is. Taking your ROCE analysis as an example, you say the CMA did not do that itself, and you rightly acknowledge there are some difficulties with that, but you say that it is at least informative in a particular way that we will come to later, is that correct? You say it is informative?
A. It is partly correct. They did a return on capital employed analysis for Pfizer --
Q. Not for Flynn?
A. No, but they did one for Pfizer, and I think that in itself is informative because the rate you give to Pfizer also informs the rate that you can use for Flynn given that before they came into this relationship it was one integrated supply chain. Now we have broken the supply chain up into two different parts, and obviously those two have to be correlated in some way, they are obviously connected.
Q. Mr Harman, I appreciate that you want to give full answers to the tribunal but in some cases you are going off on different areas that I have not asked you about,

and if you carry on doing that we are going to be here for three days, rather than two. I do not mean to be disrespectful.

MR HOSKINS: Sir, I do not think the witness should feel constrained. You made the same point to me. If you find it unhelpful you will tell him, I do not think it is for Ms Bacon to direct his answers.

THE CHAIRMAN: I am waiting to see how it develops, Mr Hoskins. It is fairly early days, I think a certain amount of give and take is reasonable.

But I think it is probably right, Mr Harman, that if you give your entire evidence in answer to every question we will be here a long time, and you do not need to do that.

MS BACON: And I am going to come to these points.

A. I do apologise, but I think some of these first points are quite fundamental, putting stakes in the ground, so hopefully I will not have to come back to them later.

THE CHAIRMAN: I think that is why they are being asked first.

MS BACON: So would you say that a cross-check is helpful, even if it is not the preferred methodology or the preferred parameter, but is at least informative or potentially informative as to the result?

A. As a hypothetical, yes, I would agree that those types

of cross-checks may, so long as you do not doubt their credibility.
Q. So your position is that something like your ROCE cross-check can be informative even if not perfect?
A. Yes, I think that is true.
Q. Would you also say that it is not -- I think it is picking up on what you have just said about doubting the credibility of the cross-check. You say it is not useful to do a cross-check with a methodology that is so far removed from what would be acceptable accounting or finance practice in the relevant context that it does not provide any useful information?
A. Sorry, could you repeat that.
Q. So if you decided that the methodology that you were using as your cross-check was actually wildly different from what anyone would normally do, then would you say that that was not particularly useful?
A. I think that is true.
Q. Right. Would you also agree with this statement: if you are providing expert economic or financial evidence to inform a decision-making process, and if that evidence turns on a parameter that is uncertain, you would regard it as appropriate to test that using informative or at least potentially informative cross-checks? I am asking a general question.

A. As a general question I think that is a fair point.

Q. I think you were here last Wednesday when Mr Williams was cross-examined?

A. I was, yes.

Q. At the end of his cross-examination I asked him a question about the purpose of a sensitivity analysis on a base case in general terms. His response, I do not think we need to go to the transcript, was:

"I think in general to test the robustness of the base case to see if it is wildly wrong because the sensitivity produces a very different result."

So that was his response to the purpose of a sensitivity analysis. Do you agree that cross-checks perform approximately the same purpose?

A. Sorry, I did not understand that last part.

Q. I asked him about what a sensitivity analysis is doing, why do you do it? And he said it is to test the robustness of the base case to see if it is wildly wrong because the sensitivity produces a different result.

I was asking you if you agree that cross-checks perform essentially the same purpose?

A. Yes, I think that is true, in general terms.

Q. So if your cross-check comes out with a similar answer to your base case you would say that supports the robustness of the base case?

It is not a trick question.
A. No, I am -- I am just trying to understand the question in terms of the analysis that has been performed.
Q. I am asking a general question.
A. I think as long as the cross-check that is performed is a sensible cross-check, then I would agree in general terms that that is true.
Q. Let us suppose it is a sensible cross-check, so if the sensible cross-check comes out with a quite different answer to the base case, do you agree that that would put you on notice that there might be problems with relying on the base case or at least relying solely on the base case?
A. If the cross-check came out completely different, and it was a reasonable one, would that undermine the analysis? Yes.
Q. Yes. So now I want to start some questions on the ROS benchmark, unless the tribunal has any questions about the general approach?
PROFESSOR WATERSON: I have one question, which is you seem to elide two concepts, capital employed and investment, they are not the same concept, obviously. So could you explain your understanding of these two concepts, how they relate.
A. Yes. I think the general theory between those two

things is -- and it is well rooted in regulation and how we regulate utilities, and those concepts have now been used in competition. But in effect there are two components: there is an amount of money that has been invested by investors, shareholders and debtholders, and they expect to receive that investment back at some point in time, and they also expect to earn a return on that. So that is the investment part: the bigger that pot, the bigger absolute return that you would require, all else being equal.

The second component is the return and that is normally referred to as the weighted average cost of capital. In effect that is a return that you would expect by investing in the market generally, adjusted for risk of that investment through what we would call a beta analysis.

Those two things together would give you your absolute return.

PROFESSOR WATERSON: But the capital, that is surely a stock concept rather than a flow, so ...

A. Yes, it is. But I think that the general competition viewpoint is could, in a competitive market, somebody enter into that market and earn a return at your price? And so what we are saying is that for them to enter, we would take the dominant company's invested capital as proxy of what a competitor would need to invest to enter the -- but it is a stock concept, yes.

THE CHAIRMAN: Mr Harman, could I ask you: in your regulatory practice, what is the rough balance between capital-intensive and capital-light companies that you look at?

A. I would probably -- in terms of capital intensity?

THE CHAIRMAN: Not a measure, but are there more companies that have large capital for which the ROCE measure is not in principle unsuitable than the other --

A. I think that much of current regulation has been based on a return on capital employed, on a ROCE basis, because they have been dealing with telecoms, gas, electricity, water as integrated entities, so pretty much most of regulation up until the last ten years has been on that basis. Regulation has now started to change because it has introduced competition at the supply end of the spectrum and there has been a relevant question now that: as I break up a vertically integrated entity, how do I regulate the supply part which in effect is just a customer list business? I have a set of customers and I can market to them. And so there has been a migration for those industries away from the weighted average cost of capital on invested capital to a return on sales approach and that basis of regulation is developing.

In my competition cases I would say 80 per cent of them have been based on industries that are capital-intensive and 20 per cent of them are on asset-light. One of the industries where that came up recently was in the energy market review that the CMA performed and they were looking at the returns on, again, the supply end of the spectrum. Again, that is a relevant issue.

THE CHAIRMAN: So this is a developing field.

A. This is very much a developing field. My general point is I think that the economics of weighted average cost of capital, invested capital is well understood. You could almost think of it as commoditised, people know what the approaches are. Return on sales is very new.

THE CHAIRMAN: Do not diminish your expertise, Mr Harman. Thank you.

MS BACON: I am going to now turn to some questions on the ROS benchmark. Can you take up your first report and look at paragraph 2.20. You say there that:

"The PPRS can be used as a starting point ..."

And the way that it has been used, you say in that paragraph 2.20, subparagraph (1), is that:

"The CMA has identified the broad PPRS portfolio average and then considered the various risk and investment dimensions to see whether the return for Phenytoin is likely to be above or below the average PPRS benchmark."

Do you see that paragraph?

A. Yes. I do not state there that it is the starting point.

Q. No, you just say the PPRS can be used as a starting point. Just to --

A. Yes.

Q. -- check what you mean by "average PPRS benchmark", do you mean the 6 per cent?

A. Yes.

Q. Then if you --

A. Can I just clarify what I mean there by "starting point". Because obviously the PPRS is a portfolio, obviously when you look at the 6 per cent that has to be the starting point because we are trying to find a return for a particular product within that portfolio.

Q. Yes. So you make the same point at 2.23. You say:

"The CMA identifies a benchmark, the PPRS, which contains a higher number of companies and products. It then assesses the risk and investment of Phenytoin against that benchmark. The CMA concludes that Phenytoin is less risky and requires less investment than the benchmark average and it concludes that the benchmark average provides a conservative estimate of the reasonable returns for Phenytoin."

Can you fast forward to 4.43, which is a more detailed section of your report, and I think you make the same point there.

Can I summarise that this way: so you are describing what the CMA has done, and your evidence from those two paragraphs that I have taken you to is that there are two main conceptual steps in the CMA's logic. Firstly, the identification of a starting benchmark, and you just explained that concept, a starting benchmark, and secondly, a comparison of the risk and investment of Phenytoin against that starting benchmark to see whether Phenytoin should be above or below it. Is that right?

A. Correct.

Q. So is it correct then to say that the CMA starts from the PPRS figure, step one, and then looks at other factors such as the levels of risk and investment to see whether those other factors imply that for Phenytoin the benchmark should be higher or lower?

A. Yes. When it is considering the PPRS benchmark its starting point is to take the 6 per cent for the portfolio and then to consider whether it is higher or lower than that benchmark.

Q. And you endorse that approach, is that right?

A. I think that is a reasonable approach.
Q. Just going back to the discussion we had about your conceptual framework, am I right in thinking this is one of the places in your analysis where your conceptual framework feeds into your conclusions?
A. Yes.
Q. So when you are talking about the reasonable rate of return for the product, and when you are referring to risk and investment to inform that reasonable return, what you are doing as an economist is to look at a reasonable return in light of the risk and investment characteristics of Phenytoin?
A. Yes.
Q. Could you look at the decision again, please. 5.163, and you will see three bullet points. Am I correct to think that your evidence is that the starting benchmark chosen by the CMA is the third of those three bullet points?
A. No, I think what I just -- I tried to make that clear. I think what it says somewhere around here is that it considers all of these pieces of evidence in the round, is what the CMA says.
Q. But we are talking about the starting benchmark and you agreed it was the 6 per cent portfolio ROS, and I am just asking you which of those three bullet points

produces the 6 per cent?

A. But I think this is where we are slightly different. I said when you are looking at the benchmark for the PPRS, your starting point is the 6 per cent within the PPRS, and then you are asking the question: where, from that 6 per cent, does your analysis take you? I am not saying here that the CMA started with the PPRS.

Q. I am just looking at your report, paragraph 4.43:

"Conceptually the CMA considers the broad PPRS portfolio average and then considers various risk and investments dimensions."

I think you agreed what it had done was started with the 6 per cent PPRS and then looked at whether that was going to be too high or too low. So given that you agreed with that, I was asking you which of those three bullet points produces the 6 per cent?

A. But I think you have to read the first sentence carefully. It says:

"First, I understand that the PPRS regulator portfolio profitability rather than individual --"

Q. Maybe we are looking at the wrong part of the decision. It is paragraph 5.163:

"The CMA has considered the following possible benchmarks ..."

First bullet point:

"Flynn's internal ROS."

Second:

"Other companies' ROS rates."

And third bullet point:

"The allowable ROS under the PPRS."

Given you have just agreed, and it is in your report, that the first step was to consider the PPRS portfolio average, I am just asking you: do you agree that the third bullet point was the CMA's starting benchmark?

A. I think you have to look first at what the CMA says and then look what I say. If you look at 5.164 in the decision, and if you look towards the bottom of that, it says:

"Weighing up all of these factors in the round, the CMA has determined for the reasons set out below that a 6 per cent ..."

It does not say there that it has started with the PPRS.

What I say in 4.43 of my report is that, first, I understand that the PPRS regulates portfolio profitability rather than individual product profitability. However, the benchmark:

"The PPRS can be used as a starting point in the determination of a reasonable return for a specific product."

So again, what I am saying there is that if you take the PPRS as a particular benchmark, and your question is: given this one benchmark, what do I do with it? You can take the starting point as 6 per cent and then you ask yourself: is it higher or lower?

Q. I think that is where we come out. You say you take the starting point of 6 per cent and you consider whether it is higher or lower.

A. But I think you are inferring something slightly different to what I am inferring.

Q. No, I was just asking you which of those three bullet points was the starting point, but let us move on --

A. I think if you want to go in chronological or in ordering turn, Flynn's internal ROS is the first point in this list and it goes on from there.

Q. Yes, and that was not the starting point, was it? The 6 per cent was the starting point?

A. It says here the CMA says:

"Weighing up all of these factors in the round ..."

Q. All right, so let us move on. You have said in your report that the first step is to look at the starting benchmark, and I understand what you then say about considering whether that is too high or low by reference to other factors, but I just want to be clear about what your evidence is regarding the appropriateness of the starting benchmark. You just said to the tribunal, and you have said in paragraph 4.43, that PPRS can be used as the starting point?

A. I think we are still at odds. I am saying one thing and you are cutting across me and saying something different.

Q. I am just asking you whether your evidence is still what you say in 4.43, which is:

"The PPRS can be used as a starting point ..."

And I am just asking you whether that is still your evidence?

A. Okay, so let us just be clear with what I am saying, and I am sorry to be repetitive. To be clear, I think the PPRS is a benchmark that is informative. When you take the portfolio of the PPRS, which is a 6 per cent return, you can take that 6 per cent return within that benchmark as a starting point to determine whether a product within the PPRS is likely to have had a return that is higher or lower than the 6 per cent. I am not saying that when we do this analysis we start with the PPRS and then cross-check everything else.

Q. I am not sure ...

MR LOMAS: I think it may help -- paragraph 4.43 of

Mr Harman's report is where he is addressing the appellants' specific arguments under the heading "The PPRS Industry Benchmark".

MS BACON: Yes. I am trying to understand what he is saying, because he has said it can be used as a starting point, and I took him to the paragraph 2.23 where he set out the CMA's approach looking at a benchmark average. What I was trying to establish was whether he still thought that PPRS was that benchmark average but it may be that we are actually in violent agreement but with different words.

A. Just to be clear, I think the PPRS is a relevant benchmark, but I do not order it first amongst the others. There is a whole load of analysis that goes in, some of it quantitative, some of it numerical, and all of those points are taken together in the round to come up with whether 6 per cent is a reasonable return.

Q. Right. Do you agree this: the only source of the figure of 6 per cent, the only place where a figure of 6 per cent is specified, is the PPRS?

A. I would agree that the only number that comes out is 6 per cent, but you have to think --

Q. That is not what I was asking. I was saying: where does the 6 per cent come from? The CMA had to -- do you agree it came from the PPRS?

A. I agree, but let me just put the context. If I had five data points and it was 1 per cent, 2 per cent, 3 per cent, 4 per cent and 6 per cent, and that is the analysis that you have in the round, it would be generous of the CMA to say, "Well, I will take the highest one at 6 per cent because it is higher than all the other four". That is not to say that it is putting primary weight on that benchmark, it is saying in the round there are lots of returns that are below, and to be generous we are going to adopt 6.

Q. Assume we actually had a number of data points, one was 6 per cent and one was 21 per cent, and then one had Flynn internal ROS, so what it did was to take the 6 which was the PPRS?

A. That is not correct. So the ordering of the document first considers Pfizer, it considers Pfizer, it looks at its threshold at which it put its products under review, it looks at Pfizer's own profitability, it did a weighted average cost of capital ROCE cross-check, it did a qualitative analysis of risks and it concluded that a return of 6 per cent would be generous to Pfizer.

It then addresses Flynn having already put a stake in the ground on Pfizer. Its starting point is, well, actually when we look at Flynn, it is now only doing a very limited number of activities and has low risk, so a priori we do not believe that it needs a higher return than Pfizer.

It then -- and this is where you pick it up in the decision at 5.166, the activities and risks incurred by Flynn. It goes through that analysis, and then it brings it back to the Pfizer point when it looks at Flynn's rate of return in absolute terms at table 5.15 and it makes the observation that a 6 per cent return for Flynn would be very generous in comparison to the absolute level of return that had been allowed for Pfizer.

Q. We will --

A. But there is all of that in the round that went into the decision.

Q. So taking that point on its own terms, where in 5.163 does it say that the CMA has considered Pfizer's rate of return as a benchmark for a reasonable rate of return for Flynn?

A. What you have to do is you have to look at the paragraphs from 5.183 to 5.186 where it concludes --

Q. I am not asking you about the absolute rate of return --

THE CHAIRMAN: You have to be careful, Mr Harman. You have counsel who will argue the CMA's position. You are here as an expert witness to give your opinion on what these issues tell us, so I think you must be careful not to move off into defending the decision, which you may or may not think is under attack, but it is not your position really to do that. I appreciate your wish to put the context but I think you must try to avoid doing so by becoming an advocate, if I may say so.

A. I am sorry, I am not trying to be an advocate. Obviously I know my place in this courtroom. But I was asked to analyse what the CMA did in terms of coming up with a 6 per cent return. So in concluding --

THE CHAIRMAN: But all you can do -- sorry to interrupt you -- as an expert is to give your view as to what they appear to have done.

A. I am sorry, yes, that is true.

THE CHAIRMAN: Otherwise you are getting a little close.

A. True. But when I do my analysis, sir, I also do that analysis and I ask myself the question: do I think, as an economist, this is a reasonable piece of analysis? And I think that what they have done here is reasonable based on my economic ...

THE CHAIRMAN: Okay. If we could maintain that stance then, please.

MS BACON: I will move on, sir.

If you can take up your report again and look at paragraph 4.44.

A. Yes.

Q. You have said in 4.43 that the PPRS can be used as a starting point, and you are looking here at the appellants' arguments that the PPRS cannot be used as a starting point. Then at 4.44 you give a reason for saying that the PPRS can be used as a starting point, and your reason, as I read it, is that the PPRS accounts for 80 per cent of the NHS drug purchases.

So just looking at this paragraph of your report, am I right to say that your evidence is that the 6 per cent rate is a reasonable starting benchmark because it is the rate applied to the 80 per cent of the NHS drug purchases?

A. I think the quality of the benchmark is reasonable because it is 80 per cent. I think there was some evidence last week that said that might be as low as 50 per cent.

Q. I am coming to that. So the 80 per cent figure, taking that at its face value, that is a figure by value rather than volume, is it not?

A. I am not sure but I take your word on that. I do not think much turns on it. It is a high number.

Q. I am just trying to establish what the 80 per cent is of. You have given as a footnote reference Mr Williams' report, and his report refers to the 80 per cent as being by value?

A. Correct.
Q. So you are referring to the PPRS as accounting for 80 per cent by value of the NHS spend?
A. Yes, it says "by purchases", yes.
Q. Do you know where the 80 per cent figure comes from?
A. As I said, I have taken it from Mr Williams' --
Q. You just took it from Mr Williams and you did not do any research yourself to verify that figure?
A. No, I did not.
Q. You have just said you heard Mr Williams' evidence last Wednesday that the PPRS spend during the relevant period was actually substantially lower than 80 per cent. He said close to 50 to 60 per cent. Were you aware of that when you were preparing your reports earlier this year?
A. No, I was not.
Q. At the end of Mr Williams' cross-examination, Professor Waterson asked him why he thought the 80 per cent figure, which he explained was an old figure quoted by I think the ABPI, had dropped to nearer 50 or 60, and Mr Williams answered that he thought there were two or three reasons driving that. One was the fact that generics were a more important part of the drugs bill, the second was that parallel imports have increased fairly materially, and the third was that

a number of companies had elected not to join the PPRS.

For the purposes of your report, did you do any research on the number of UK pharmaceutical companies that were within the PPRS as opposed to without the PPRS?

A. No, I did not.

Q. Have you done any research on the actual ROS rates of the companies who are outside the PPRS?

A. No, I have not.

Q. Did you do any research on what percentage by volume of the NHS medicines were accounted for by the PPRS?

A. No, I did not.

Q. Can you be handed, please, bundle N, and can you turn to tab 14. No, let us start with tab 15. This is an NHS statistics document. This is one of the additions to the bundle over the weekend. Can you see the front page behind tab 15?

A. I can.

Q. This gives a graph showing the generic mix. So my understanding, and obviously you have not seen this before, so if you have any further comments you want to make on the veracity of this you can do so tomorrow, but this shows at least that generics seem to have accounted for about 75 per cent of the proportion of products dispensed by pharmacy contractors, if you read the text

underneath.
A. Yes. I mean obviously I am only seeing this for the first time, and I have no idea how the data is, but I can see what it says.
Q. Of course, exactly. If you then go back to tab 14 and you turn the page, this is an OECD document from 2016, and if you look at the first column on the second page, just above the graph you will see the words "In 2014"?
A. Yes.
Q. "In 2014, generics accounted for 84 per cent of the volume of pharmaceuticals sold in the United Kingdom, the highest among EU countries."
Obviously I will ask you tomorrow if you have any comments you want to make -- any further comments you want to make on those statistics, but just taking those at face value for the time being, assuming they are correct, it looks like generics now account for at least 75 per cent of the market by volume and possibly even higher.
Can I take it from your responses that you were not aware of those figures when you wrote your reports?
A. I was not. I am not sure it would impact what I have written in my reports.
Q. I just wanted to see if you knew of them. So do you agree that if those figures are right, then branded

products within the PPRS -- let us just take this in stages. Branded products must account for 25 per cent or less by volume, is that right?
A. There or thereabouts.
Q. And because some companies are not within the PPRS, and you do not know how many but there are some, it does mean that branded products within the PPRS must account for less than 25 per cent by volume?
A. Of the market.
Q. Of the market.
A. Yes.
Q. And possibly much less if the OECD figure is to be believed?
A. I have no data to be able to confirm or deny that. My point, though, is that the PPRS quite clearly contains a lot of companies and a lot of drugs, but the --
Q. But you do not know --
MR HOSKINS: Please. Continually interrupting the witness is not acceptable.
A. But the quotation of the 80 per cent just says this has a big sample size within it, and that gives it a degree of credibility. That is the only point that is being made about the 80 per cent.
MS BACON: Right. So in paragraph 4.43 in the last line, when you refer to the "average PPRS benchmark", and when

you refer in the middle of 4.43 to the "broad PPRS portfolio average", are you there referring to the 6 per cent?

A. I am.

Q. Have you done any analysis of the average ROS rates for PPRS companies, for example, by looking at their statutory accounts?

A. I have not. I have relied on the information contained in Mr Williams' second report.

Q. Have you done any analysis of the ROS for any company within the PPRS other than Flynn and Pfizer?

A. No, again I rely on the data that has been prepared by Mr Williams in his second report.

Q. So you do not actually know what the broad PPRS portfolio average ROS is, do you?

A. In terms of out-turn? I have an idea because the information is contained within Mr Williams' second report. But I think that there is an issue here as to whether I am relying on what the regulated benchmark is as an indicator of a return or whether companies are earning more or less than that in out-turn. I think what I am relying on is the benchmark as opposed to the out-turn, but we do have some information from Mr Williams in his second report.

Q. I am going to ask you about that in a minute. So when

you say the "broad PPRS portfolio average", do you accept that because you do not know what the broad PPRS portfolio average is, you are actually referring to the target ROS within the PPRS?
A. Correct.
Q. So when you say "average", that should be replaced with the word "target"?
A. In which paragraph, sorry?
Q. In 4.43, you use the word "average" twice.
A. Yes, I think that it refers to the target.
Q. Right. So we will just write "target" in, rather than "average".
Do you know how many companies hit that target?
A. I do not know but --
Q. Did you do --
A. -- there is some information in Mr Williams' second report.
Q. Did you do any research to see how many companies hit the target of 6 per cent, or come in at 6 per cent or below?
A. No, I did not. And just to clarify, my instructions were to review the evidence that the CMA had relied on and the evidence that had been put forward by the appellants. So my work was constrained, and I set that out clearly in the first section of my report.

Q. So when you say in paragraph 4.44:

"I consider an assessment based on a portfolio covering approximately 80 per cent of the NHS drug purchases."

You are not saying in that sentence, are you, that 80 per cent by value of the NHS drug purchases hit the 6 per cent?

A. No, what I am saying is that 80 per cent had a target return of 6 per cent.

Q. You have seen and you have heard Mr Williams' evidence that you have to submit an AFR under the PPRS if you are above a certain threshold or if you are applying for a price increase on the grounds of insufficient AFR profits, but otherwise he says you do not have to submit an AFR unless the Department of Health specifically requests it on an ad hoc basis.

Do you know what proportion of companies within the PPRS do submit AFRs?

A. Not to hand.

Q. Have you done any research to see what the average return on sale is for the companies that do not submit AFRs?

A. No, I have not.

Q. So returning to paragraph 4.44, we now know that on Mr Williams' evidence the PPRS covered only 50 to

60 per cent of purchases by value during the relevant period. If the figures I have just shown you are correct, that was less than 25 per cent by volume, maybe even much less. You do not know how many companies were in the PPRS, you do not know what the ROS rates of the companies outside the PPRS were, you do not know what the actual average ROS is for any company within the PPRS. Does not all of that fundamentally undermine the reasonableness of taking a 6 per cent benchmark?

A. No, I do not think that it does. My understanding of the PPRS is that it sets a target rate of return of 6 per cent, it allows a margin of tolerance above that, and as soon as you are above that margin of tolerance you have to pay back an amount of money between the difference above the margin of tolerance. It is a maximum level, the margin of tolerance.

So I take the 6 per cent at face value as an indicator of a regulated return believing that for those companies where it is enforced they would have to earn a return lower than the 6 per cent or lower than the margin of tolerance. There is a second question as to whether those companies that are not providing the returns, because they do not have to because of their size, are earning a higher return, and I refer to this in my second report. As I understand it, the PPRS can be enforced, you are allowed to look at the returns to see if it is going to be above 60 per cent, so I had my analogy in there of --

THE CHAIRMAN: 6 per cent.

A. 6 per cent, yes.

THE CHAIRMAN: If it was 60 per cent we probably would not be here.

A. Sorry. It is my analogy that says if you are speeding on a country road and you get away with it, that does not mean the law was not there.

So my point is, and it is for the tribunal to determine, I look at the target rate as something which I think is as illustrative of what the PPRS sets out to be the return that you should be allowed.

There is a second question. If companies are not complying with it because they do not have to file returns then that is another matter. That is not for me to determine whether that is a legal thing and whether the return should be based on that. I just say I look at the target and take that return.

MS BACON: I think we have understood your evidence on that now, Mr Harman. Can you turn over the page and look at paragraph 4.46. In that paragraph you quite candidly say that it might be possible to adopt a more specific benchmark than the PPRS based on comparables with similar risk and investment profile. But then you make the point that you made to the tribunal at the start, that you think the comparator would need to be comparable across a range of different factors which you set out there and you explained earlier on.

That is why you said, and you said this morning, that Flynn's suggested comparators are not comparable, and you say that is the reason why those cannot be used to derive the starting benchmark.

A. I do not actually say they are not comparable, I say I had no information to know whether they are, and the devil is in the detail, and because the returns have such a big spread I would be cautious of looking at that as a benchmark because I do not know what it would tell me.

Q. Right. You have not carried out any analysis of whether Phenytoin is comparable to the products that are assessed under the PPRS under those criteria, have you?

A. No. But I have relied on what the CMA has done in terms of its assessment of risk and investment.

Q. But the CMA has not, as far as you have seen, done an assessment of whether Phenytoin is comparable to the products that are assessed under the PPRS on all of the factors that you set out in paragraph 4.46, has it?

A. I think it does. Let me just give one example. The first aspect, and it is probably a large aspect, is the level of investment. I know that within the PPRS there are lots of drugs which are new, innovative, and I think it is easy to assume that they have required a level of investment above a certain level. I am kind of conscious of what numbers I am allowed to say and not allowed to say. But we do know the level of investment that Flynn incurred in investing in this and it was very, very little.

So I do not think that it is difficult to assume that compared to the average level of investment in the PPRS, Flynn must be towards the lower end.

Q. I am going to come to that in a minute. But do you agree that you have not applied your own test of comparability in 4.46 to the PPRS benchmark?

A. What I have done is, as I have looked at the CMA's assessment of risks, I am not an industry expert so I cannot actually do that analysis from first principles myself, I explained where they had done that in the decision document. If those facts are true, and I cannot comment on whether they are true, my assessment as an expert in setting rates of return would be that this is towards the lower end of the risk and investment spectrum.

Q. I wanted to come on to that. You said you are not an industry expert, so is it right to say that you have no experience in assessing risk and investments in the generic or branded pharmaceutical industry generally?

A. That is what I said. If I was to do this from first principles, I would not know what risks to look at. But if somebody tells me that there are indemnities within a contract between Pfizer and Flynn, then as an expert I am able to interpret what that would mean on a spectrum of risk and investment. If I know that they order every two weeks and their level of stock is low, that is a factual point. As an expert I am able to determine whether I believe that it is at the low end of the spectrum.

I know, for example, that if it outsources its distribution, which is a fact that I think is not contested, all other things being equal that will lower its overall level of risks because that is the risk incurred by somebody else. We know, in comparison to other Flynn products, it has very low sales and marketing costs because it is a very old drug. That is very well-known.

So again it is easy to imagine that that is going to be at the lower end of the spectrum than the upper end of spectrum. I agree that it is a qualitative assessment but it is something that I have looked at,

and I think that if those facts are true this is a low investment, low risk product.
Q. We do have an expert on that in the form of Mr Davies and I see you were provided with his report and I see you have referred to his evidence --
A. Yes.
Q. -- in one of the footnotes, footnote 163. Were you in court when Mr Davies was being cross-examined?
A. I was indeed.
Q. So you will have seen and heard that he has given expert evidence about the relative importance of Flynn's various activities. And he explained in his cross-examination that that evidence came from his industry experience, many years of working in the industry, as well as information obtained from Flynn.
Am I correct to say that it is not within the scope of your expertise to rebut his specific industry evidence in that regard?
A. I am not. As I said, once a set of risk factors are presented to me, and you have the CMA's on the one side and you have Mr Davies' on the other side, then I am able to evaluate them both. I do not dismiss what Mr Davies has to say about risks. I have looked at those risks and I do not -- well, the first point

I would say is clearly there are risks, there are always risks in business, and he identifies some risks which are common across pharmaceutical firms. I accept that there is a degree of risk. But there are other risks that he talks about in terms of quality that we know, that Pfizer has given Flynn an indemnity, that would be a risk that he identifies that has been diminished.

He also raises a risk about stock and having to deal with that. Now, I had considered stock. When I do my WACC analysis, my ROCE analysis, I look at the level of stock that Phenytoin actually has and I conclude the level of stock that it holds does not justify the returns that it is earning.

So again what I would say is I am not an industry expert. The risks have been presented and I have analysed those risks in a qualitative and in some instances quantitative way and believe that overall this is a low risk industry. Yes, it has some risks. Obviously it does.

Q. But you did not carry out any empirical analysis of the risks and investments for any company within the PPRS, other than Flynn and Pfizer, did you?

A. Yes and no. Because when I have done my analysis of the return on capital employed approach, I did have to come up with a weighted average cost of capital, which I came up at 8 to 12 per cent. 8 to 12 per cent is not significantly -- it is not massively risky, I would say that is of average risk. But in coming up with the upper range of that at 12 per cent, I think that is generous. Because at the back of Mr Davies' witness statement --

Q. I am sorry to interrupt. I asked a question which is whether you did any empirical analysis of any company within the PPRS to look at that company's risks and investments?

A. Yes. We looked at the weighted average cost of capital of Pfizer. Pfizer, to my knowledge, is within the PPRS --

Q. I asked "other than Flynn and Pfizer" in my question.

A. I have looked at that. And then I was going on to say that in Mr Davies' witness statement, at the end of it there is an annex which looks at valuing -- I think it is in Mr Davies' -- that looks at investment returns or investments in the pharmaceutical industry, and in there it talks about what it thinks is a weighted average cost of capital for the pharma sector. In there it says it believes a weighted average cost of capital below 8 per cent is normally used. Now, the weighted average cost of capital tells you something about the risks of these businesses and actually that is telling me that it

is not that high.
Q. Can I ask my question again. Did you look at any company within the PPRS, other than Flynn and Pfizer, and do an analysis of that company's risks and investments overall, without relying on assumptions or general figures that you get from somewhere else?
A. No.
Q. Right --
A. But I have relied on Mr Davies.
THE CHAIRMAN: Is this a good moment to pause?
MS BACON: I have a couple of questions left on this topic, if you would not mind. Four in fact.
THE CHAIRMAN: Four questions. That is not a couple.
MS BACON: I have four bullet points and they are not all questions, but anyway --
THE CHAIRMAN: I think I would prefer to break now.
Mr Harman, is the sun troubling you? It is coming through the windows rather brightly.
A. No. I am trying to look this way mostly (indicating).
THE CHAIRMAN: We can arrange for it to be shut out if you want.
We will resume in 10 minutes.
(11.43 am)
(A short break)
(11.53 am)

MS BACON: Mr Harman, I just have a few more wrap-up questions about risks. Can you pick up the other expert bundle, which is bundle D, and turn to tab 13 and look at Mr Williams' third report. Can you go to paragraph 15 of that.
A. Yes, I have that.
Q. You will be familiar with this part of his report. He is talking about limited risk distributorship models, or LRDs as I think it would be convenient to refer to them as.
    If you turn over the page and look at subparagraph (b), what Mr Williams is saying here is that under an LRD model there is actually little or no risk for the UK distributor, the UK SMDC which is the company that is being assessed under the PPRS, because both the risks and the rewards are shouldered by the parent company.
    He said at the start of paragraph 15 that most of the companies that submit AFRs under the PPRS operate this LRD model. Do you have any reason to disagree with that as a matter of fact?
A. No, I can just give what I understand one of these models to be and I think that it is important. Basically an LRD model has come about when companies want to restructure for tax purposes and they take

certain of their activities into tax jurisdictions that have lower tax. Obviously the Revenue service allows that under certain and important conditions.

The transfer price between on the one hand the manufacturing company and the distribution company, those risks have to be properly accounted for and determine the level of profit. So when the manufacturing company has a transfer price to the UK, the profit that it is allowed to charge has to be commensurate with the risks that are undertaken in the foreign jurisdiction. And in the UK effectively what it is saying is what we are expecting is a level of return in the UK that is commensurate with the risks that you are undertaking in the UK and obviously there is a transfer price between the two of them.

Now, the concern that I have with what is put forward is that the implication is that the parent company can change the transfer price as it likes, to be able to manipulate the profits in the UK, ie to limit those profits. But that is not my understanding of how transfer pricing works, which have to follow guidelines like the OECD guidelines, which basically says your transfer price has to be at arm's length. You cannot manipulate it. If you were investigated and found to have a transfer price that had an inappropriate level of profitability, that would be taken into account when assessing the affairs of the UK entity.

So that is my understanding of those models. And what I take from this in my report is that if HMRC has said that if you are an entity in the UK that has limited risks, you distribute and you market and you sell, then for our purposes we think a 3 to 5 per cent return is appropriate, but you are going to have to make sure that your transfer prices are at arm's length.

They may or may not be investigated, but if the proposition is that they are not then that goes back to the point that I said before. There is a distinction in economics that says whether that is reasonable, there is a different point in law as to whether people are complying or not.

Q. So you do not disagree with the proposition that most of the companies that submit AFRs under the PPRS do operate this model. And you do not disagree with the proposition that under the model, however it works, you have just explained and Mr Williams has given evidence on it, the effect is that the risks are shouldered by the parent company?

A. No, I do not see it in that way. I think that the risks in the foreign jurisdiction attach to the risks of that entity in that jurisdiction and the risks of the UK entity are shouldered by the UK entity. That is the general way that transfer pricing works between international companies.

Q. Right. But because the product is sold under the transfer price arrangement, what the UK entity is doing, it is an SMDC, it is essentially sales, marketing and distribution. That is why its profitability, the ROS, is set between 3 and 5 per cent. It is set at that level -- if I can finish my question -- because that is all it is doing?

A. Correct. And just to bring that back, that is all that Flynn is doing. So in the UK that is what it does.

Q. Flynn does not have a parent company at all, does it?

A. No, it does not.

Q. So it does not have any company that bears any of the risk associated with its part in the supply chain?

A. That is correct.

Q. So if you are comparing Flynn's risk to the risk of the average company under the PPRS, should you not be expecting a higher ROS for Flynn because it does not have a parent company that supplies it with products in the transfer pricing arrangement?

A. No, I think this is a misconception. If Flynn had an affiliate company that was in Germany, then its German entity would be allowed to earn a return and its

UK entity would be allowed to earn a return, and the return that the UK entity would be allowed to earn would be 3 to 5 per cent. The German entity may be able to have a higher return but it would have to be justified in the transfer price.

I think what is important is that when the cost plus analysis is done, that margin from the foreign entity is included in the transfer price.

Q. I am just going to come to that. So you deal with this in your evidence at 4.56 and 4.57 of your first report, but because you come back to this in more detail in the second report it would be more helpful if we went straightaway to your second report. Let us go to paragraph 4.6 of your second report.

A. Could you repeat the reference.

Q. 4.6 of your second report. A lot of what you say in paragraphs 4.6 and 4.7 is recording points on which you have been instructed by the CMA and you said at the bottom of 4.7 that you are not an expert on the PPRS. So I am going to try and confine my questions to the points that do seem to be your evidence.

If we can start with 4.7, subparagraph (1).

A. Yes.

Q. You make a point about the 17 to 18 per cent and that is a reference to the table in Mr Williams' second report, is it not? I think you referred to that earlier?

A. It is.

Q. Shall we just look at that table, I know it is elsewhere in the bundles. So that is at tab 12 of volume D, page 9. You will have heard Mr Williams being asked about this last Wednesday and you will have heard his explanation that the figures in the table are a result of the various different allowances and adjustments in the PPRS scheme.

I am not going to ask you how those adjustments work in detail, that is the subject of his evidence and not yours, but I just want to take you to see what Mr Williams has said to see whether there is some common ground.

Can we start with his paragraph 31 under the table. He is explaining here that the "Company" column in this table will take the figures that are submitted by the companies in their AFRs and that those in turn are derived from their statutory accounts. But he says that in preparing the AFRs, in preparing the "Company" column, what they will do will be to amend their statutory account figures in the various ways that he describes, in particular by injecting costs from outside the statutory accounts, that is his (a), and grossing-up their R&D expenditure, that is his (b).

You will have seen he says that what the Department of Health then does when it looks at the AFR is to make various adjustments to the submitted data, so adjusting the data submitted in the "Company" column, and it also includes the transfer price allowance adjustments.

The extract from the report to Parliament that he cites, in the second paragraph under table 2, says:

"The result of making those adjustments and adding in things like the transfer price adjustment gives you an out-turn ROS of much more than would be implied by the data originally plugged in as set out in the 'Company' column."

So do you agree with his description of what this table is doing insofar as you understand the point?

A. I do, yes.

Q. Can I turn to paragraph 19, back a couple of pages. That may be a wrong reference. Yes, it is Williams 3, the next tab. Paragraph 19. He deals with this again there.

Going through this in some detail to see what you do agree with, start with subparagraph (a) and the second sentence:

"The real profitability in the NHS supply chain is not reflected in the out-turn figures because of the transfer price analysis."

Do you agree with that?
A. Yes, I agree with that.
Q. Are you able to agree with subparagraphs (b) (i) and (ii) on the basis of what you have been told about the PPRS or do you not know enough about it to offer an opinion on those? They were the points about injected costs and grossing up.
A. I have read the scheme and it seems to accord with what the scheme says.
Q. Right. So do you agree then that the effect of those two adjustments, the injected costs and the grossing-up, would be to suppress or understate the reported profitability by comparison with the statutory accounts of the companies?
A. Can you say that again, please.
Q. There are two adjustments that are made when a company submits its AFR. It takes its statutory accounts, but then it injects costs from outside the statutory accounts and it grosses up R&D in the way that he describes in (ii). What he then says is that this would be to understate the reported profitability, do you agree? Because both of those would have the effect of increasing the cost that is stated in the "Company" column?
A. In the "Company" column. Yes, I agree, yes.

Q. So over the page then, do you therefore agree with the paragraph starting:

"It follows from the above ..."

That is the point I have just made.

A. Sorry, in 12 or 13?

Q. So in 19, second page at page 8:

"It follows from the above that the assessed out-turn AFR report profits are materially lower than shown in the statutory accounts of the SMDC as they include a category of costs which do not appear in the SMDC's accounts and ignore a category of income ..."

And so on. That is the point I have just put to you.

A. Yes, if you incurred R&D; you cannot just inject ...

Q. Yes. So do you therefore agree with subparagraphs (a) and (b), and I leave out the words in the first sentence, "it is not a meaningful", I know you do not agree with that, but do you agree with 20(a) where he says:

"The 6 per cent figure bears no relation to the actual profitability of the small group of PPRS members whose profitability is controlled by reference to AFRs."

A. I think this is where we are in disagreement. This is where we appear to have a consistency issue, if I can put it that way, and I explain that in 4.7(2) in my report.

Basically what I am saying is -- and it is something that I can see from the numbers to be true -- that when we are presenting the figures in the "Out-turn" column, we are taking the entity as being vertically integrated. We are saying let us combine the two companies as if they were vertically integrated.

Now, given that the manufacturing company will have lots of capital, obviously it is going to earn a high return on that, so when we integrate the firm as one, then quite clearly its profitability will go up and that is my understanding of what this PPRS scheme is doing. If we consider this as an integrated entity, then it has to have a higher return. That fully accords with my conceptual framework that I set out: higher capital invested, higher return.

It is interesting --

Q. Mr Harman, I am going to come on to 4.7(2). I was asking you about whether you agree with 20(a), and I was simply saying if you agree that the figures that are submitted in the "Company" column in the AFR are not the actual figures from the statutory accounts but are inflated figures, in the sense that there is an injected cost and also a grossing-up of R&D expenditure. Now, you agreed that that would understate the actual profitability --

A. Of the company, yes. But I think 20 is talking more generically, I do not think it is talking about the company, it is talking about both. It is saying the answer is not 6 per cent. And then in paragraph (b) it is saying it should be between 17.3 and 18.5. And I am explaining that both of those answers can be true depending on how you account for things. If you want to account for it as a vertically integrated company where you include the profitability of the foreign entity then, yes, you will have to have a higher return. That is going to be higher than 6 per cent. I do not contest that.

What I am saying is that the alternative exactly equal approach is to treat it as a UK entity and the profit that comes into -- the transfer price that comes into the UK is not only the manufacturing cost but also the profit. Right? So you are treating the profit already as a cost. If you treat the profit from the foreign entity as a cost within your cost stack then the right number to look at is 6 per cent.

Just to show you back on Mr Williams' second report, table 2, just so I can explain my point in more detail so that we can see it, if we go to --

Q. I am going to come to your 4.7(2) so can we just take that when I come to it.

So picking up on the vertical integration point, you make the point then in paragraph 4.7(1) that Flynn is not a vertically integrated company. So I think what you are saying is because it is not vertically integrated, the 6 per cent figure is relevant for it?

A. Yes.

Q. So your point is that we should not be trying to compare Flynn to vertically integrated companies?

A. Yes. It was not vertically integrated over the reference period.

Q. Right. Do you agree that if Flynn did become vertically integrated, it would then be eligible to take advantage of the transfer price rules in the PPRS?

A. If it became vertically integrated as a manufacturer?

Q. No, if it became vertically integrated by adding, for example, a procurement company up the train?

A. I do not think that that is the -- so again I am going to go to what the essence of the PPRS scheme says from an economic perspective versus what people can get away with, that would be a different thing.

THE CHAIRMAN: Are you telling us, Mr Harman, what the PPRS actually provides or what as an economist you think it ought to provide in that circumstance?

A. Yes, the latter.

MS BACON: Can we stick with what it does provide. Were you in court on Day 2 when I was making my opening submissions?
A. No.
Q. Did you see the transcript?
A. Yes.
Q. And did you see my transfer price diagram that I handed up to the tribunal?
A. Yes, I did.
Q. Would you accept that all else equal, and provided it was lawful, any rational company under the PPRS would take steps to make use of the various allowances in the PPRS such as the transfer pricing allowances?
A. I can only answer that from an economist's perspective of reading the scheme. And as an economist what I would say is the assertion is that the actual manufacturer would sell to the affiliate company, and obviously that would include its cost of sales and its profit and that would go to the purchasing company. So I understand that point. The second aspect that is being put to me in this example is that then the affiliated company could then sell to the UK with an additional profit contained within its transfer price.

My question as a matter of economics is: what is it claiming that profit for? Because as I understand the essence of the scheme from an economic perspective, it said: we will allow you to take your manufacturing offshore and you should be able to have a profit for it.

As an economist, what I do not understand is why it would be permissible from an economic perspective to be able to include what would end up being a triple marginalisation point: the manufacturer gets his profit, the affiliate gets his profit, and then the UK entity.

But then there is one other aspect of the PPRS scheme that I think is interesting again from an economic perspective. It says that the transfer price has to be at arm's length, and it has to be at arm's length consistent with what you would provide to the tax authorities.

So what I cannot understand is how that affiliated company from a tax perspective would be able to claim a profit on activities that it did not actually incur. And that I think is the problem that I have as an economist reading the scheme. There is a different point as to whether companies could actually do it, and I cannot provide any evidence on that, whether that would be actually permitted within the framework.

Q. And that is Mr Williams' evidence as to what they actually do and what they can do?

A. Correct.

Q. So if we look at your paragraph 4.7(2), and I said I was going to come on to it and we are there now, you refer in lines 4 and 5 to the CMA's calculation of ROS and then in parenthesis you say:

"... which also allows affiliated company profits to be included within transfer prices."

We know there were not any transfer prices in this case, so do you agree that it is not quite correct to say that the CMA's calculation of Flynn's ROS allows affiliated company products within transfer prices? Because basically there were not any.

A. That is true, because it is actually buying from Pfizer, and the Pfizer return is in the transfer price. If in the scenario there was an affiliated company, and I think that you gave in your submission that you just passed through the calculation, so that if it bought at 65 from the manufacturer and then passed 65 through to the UK entity, with no addition to it, then clearly the transfer price that the CMA has allowed is still 65. It is still includes a profit element within it.

Q. So if Flynn had bought Phenytoin from an affiliated company instead of Pfizer, and in your example buys it at X and sells it on to Flynn at X, the CMA's calculation, just focusing on what the CMA did, its cost plus analysis, that would not have included any extra

profit allowance for the transfer price, would it?
A. If you say that the manufacturer sells at 65 to the affiliated company who on-sells it at 65, then the cost of goods that the CMA has taken into account is 65.
Q. Right --
A. So it includes profit.
Q. The CMA's ROS and the CMA's cost plus analysis does not have this extra transfer price profit allowance, does it?
A. It does. It is in the cost of goods sold of its purchase.
Q. It does not take the transfer price profit out of the cost, put it in the allowable profit, add an extra margin of tolerance to it, does it?
A. No, that is correct. But what I have to say is if you think about the cost stack that has a level of cost and a level of profit if you take out the cost and add to the profit you end up in the same place which is the point I am saying at 4.7(2).
Q. Not if you add the margin of tolerance. Because if you add the margin of tolerance then you increase the allowed profit by 50 per cent in this case, and that was the point of my example that I worked through, and that was why I said it would be insane not to do a transfer pricing arrangement because even if you bought at X and

sold at X you would still, by doing the transfer pricing arrangement under the PPRS, get an extra 50 per cent on the profit element of the transfer price?
A. We have now moved to a second topic. Now we have moved to the margin of tolerance.
Q. No, I was asking you about your point that it is exactly the same as what you say the CMA allows the transfer price profit. And I am saying actually it does not, because the transfer price profit allowance in the PPRS includes the margin of tolerance which the CMA's calculation would not do.
A. I think -- how best to put this? I think whether the margin of tolerance should be allowed is a secondary question.
Q. Yes, I am going to get to that. I am just trying to work out how the transfer price profit works?
A. So there is a question as to whether we are looking at the 6 per cent as a reasonable return versus whether it should be 6 per cent and the margin of tolerance. And we will come to that.
    But as I understand it, the transfer price profit also has a margin of tolerance attached to it. So the manufacturer in a foreign jurisdiction is also allowed to have a profit with a margin of tolerance. So from an economic perspective, that margin of tolerance is not

for the UK entity, it is for the foreign entity, and it only comes up because we are looking at this now as a vertically integrated entity.

So as a matter of economics, I am trying to put where these profits are. Can they be in the foreign jurisdiction or should they be in the UK jurisdiction? But you do not see that in a vertically integrated because it all lands in the UK.

Q. But the margin of tolerance is something that is allowed for the UK SMDC in its profit calculation.

A. It is allowed when you consider the vertically integrated company.

Q. Yes, in a vertically integrated situation.

A. Correct. And I am saying you could either look at it in the PPRS world vertically, but it gives the same result as looking at it in the CMA's world of a cost stack analysis where the transfer price includes the profit allowance within the transfer price.

So the degree to which it purchases from Pfizer and it has a profit in it, and the degree to which that profit is above the 13 per cent, it could be any number, the profit could be 50 per cent. That is included in the CMA's analysis as actual, it is not hypothetical. It takes Pfizer's actual cost and actual profit, which could in the PPRS term include a margin of tolerance, and it includes it in the cost stack.

My view therefore is that the CMA's calculation is entirely consistent with what the PPRS is trying to do.

Q. When you say halfway down 4.7(2):

"However, it would be inconsistent to compare a benchmark of 17 to 18 per cent (which excludes affiliated company profits included within transfer prices) ..."

I am a bit confused because your previous paragraph says that the 17 to 18 includes profits further up the chain. So perhaps if we just get rid of the language of "including" and "excluding", which I think is a bit ambiguous, do you mean here that the figures in the table, 17 to 18, are arrived at in part by removing a notional profit sum from the transfer price in the calculation of assessed costs?

A. Exactly.

Q. Would it be correct to say the basic point you are making in this paragraph is simply that 6 per cent is a local profit target, whereas the 17 to 18 takes into account to some extent, and with the other adjustments we have talked about, that there will have been transfer prices in the chain?

A. Correct. But the important thing to understand when you do that is that you can either look at it vertically, you have to strip out the profit from the transfer price, which is exactly what Mr Williams' table shows happening, other costs reduce and then you include it in the allowance, or you include the transfer price within the accounts of the company as a cost and then you have to look at the 6 per cent. You cannot mix and match.

Q. So your point is you cannot just compare the profitability of Phenytoin with the profitability of vertically integrated companies that have benefited from all this set of allowances?

A. What I am saying is that when you look at Phenytoin's return of 6 per cent, and take a 6 per cent, it already includes the profit from the foreign entity. So you can do the analysis in two ways: the CMA could have said "Okay, we will adopt a PPRS methodology --"

Q. It did not do that, did it?

A. No, because it is not adopting a PPRS approach. The PPRS is just one input into its calculation of a reasonable return. It does not set out to apply the PPRS. But the CMA could have done that, it could have allowed them an 18 per cent profit margin but if it did so it would have reduced the cost of goods sold coming into the calculation and that would have given them the same result.

There is no magic to it. I think there was a table that you showed in your opening that clearly shows that you take the manufacturing cost, you take off the profit, and then you take it over to the other side of the equation and add it on to profit, allowed profit. There is no jiggery pokery, it is a simple debit and credit: you take it out of cost and you put it into profit. You come to the same position.

Q. As I said, that also includes the MOT and we will come on to that. But your point is you cannot compare Phenytoin in its business with the overall situation of vertically integrated companies that would have benefited from those transfer pricing allowances and the other adjustments?

A. That is part of the argument. The second part of the argument is a consistency argument.

Q. But this point about not comparing Phenytoin with a vertically integrated company, is that not Mr Williams' point? Are you not in violent agreement about this? He says the PPRS cannot be an apt comparator because it covers companies with fundamentally different business structures and cost models to Flynn. And your point is that Flynn equally cannot be compared with vertically integrated companies?

A. No, I think that is not the point. What is the PPRS covering in the UK? It is covering sales, marketing and distribution companies on which it should be allowed a 6 per cent return and that is exactly what Flynn is. The manufacturing element is overseas.

It would be completely wrong if I said let us look at the PPRS as an integrated entity, include all the manufacturing, then clearly Flynn would not be comparable to that entity because it does not have any manufacturing, so its result would have to be much lower than 17 per cent because you are not getting a return on your manufacturing.

MS BACON: I am now going to move on to a different topic.

THE CHAIRMAN: Can I just ask you, Mr Harman, I think you said early on in discussion of this topic that the transfer price would be set having regard to the requirements of tax law.

A. Yes.

THE CHAIRMAN: I think you also said that manufacturing had been moved overseas.

A. Yes.

THE CHAIRMAN: Essentially for tax planning reasons. Is that absolutely right? I thought also there must be cost reduction aspect to it as well given the high price of manufacturing here, or at least historic high pricing of manufacturing, would you agree with that?

A. I think that is true. I think that when you get into the dealings with HMRC as to what profits you are allowed in the UK, it is not just about the cost savings, it also about them understanding that you are taking your activities to different jurisdictions.

THE CHAIRMAN: Yes, both HMRC and the Department of Health have common interests in the sense that I am sure they would both like everything to be done in a way that bears some relation to reality. I say that with some care. But the actual policy objectives of tax policy in this area and the PPRS are slightly divergent, are they not, because the PPRS is just trying to pay less, the Government trying to pay less, and tax would say, well, if you have done something in the UK then that should be recognised. There should be higher returns.

A. Yes, I do not disagree with that. There is that tension. But it does still come back to the transfer price which I think is set out in section 8 of the scheme and it makes very clear that it has to be at arm's length.

THE CHAIRMAN: Nobody quite knows how long an arm is, do they?

A. I think HMRC knows how long it should be.

THE CHAIRMAN: They certainly have their opinion. So that is the common point.

A. Yes.

THE CHAIRMAN: Thank you. Sorry, Ms Bacon.

MS BACON: One last question on that. Have you looked at how many companies within the PPRS are stand-alone companies like Flynn without any vertical integration?

A. I have not.

Q. So there might be none?

A. No companies like Flynn?

Q. It could be the case -- this is what I am putting to you -- that of the companies that submit AFRs and whose profitability is assessed under the PPRS, there is not one that is in the position of Flynn?

A. I do not know the answer to that.

Q. Can we go back to your first report and look at paragraph 4.70. This is the section of your report where you are talking about the relevance of the proposed comparators. You have made the point in 4.68, a point we have already explored this morning, that you think the competitive level of return depends on the required level of investments and risks. And then you say:

"Whether a generic firms earns higher than a branded firm will be influenced by this practice ..."

And so on, and we have explored the extent of your expertise on that.

But then you say at 4.70, the last three lines:

"Flynn in the case of Phenytoin is not acting in the usual capacity of a generic drug manufacturer."

We obviously know that Flynn is not manufacturing the drug, so are you just saying here that it is not acting in the usual capacity of a generic drug supplier because it has taken over the distribution of a drug that was branded?

A. Correct.

Q. So we should just substitute "supplier" for "manufacturer" here?

A. It is also true they are not acting as a drug manufacturer.

Q. On that we are in agreement, Mr Harman.

Have you done any research into the extent to which generic companies enter into this sort of arrangement?

A. Which sort of arrangement?

Q. The sort of arrangement Flynn has with Pfizer which you say is not usual.

A. No.

Q. So you do not have any empirical basis for suggesting that this is unusual?

A. I think it was the evidence of Mr Ridyard last week when he was looking at AEDs and the prices of those AEDs, and it was put to him whether it was relevant to look at the prices of originators --

Q. Are you giving your evidence or are you recounting what the CMA's counsel put to Mr Ridyard?
A. I am going to say that he indicated that he thought that the distinction between branded and generics was not clear in the way in which it had been asserted and that he thought from an economics point of view that this looked more like an originator branded good. As an economist that is a position that I agree with.
So what I am talking about in this section is that the drug was within the PPRS, it has been genericised, obviously it is a generic drug but it is still quasi-branded and not much has changed.
So my point only is that when I think about the economics of this drug, is my first instance to believe this is more like generic or more like branded? I believe it is more like branded as a starting position.
Q. You have done no empirical testing to verify whether this is usual or not, have you?
A. No empirical analysis.
Q. You have seen Mr Davies does give evidence about Flynn's activities, and he gives evidence about whether Flynn's activities are comparable to those of companies supplying unbranded generic medicines. You have read that evidence, have you not?

A. Yes.
Q. His evidence is that --
A. Which paragraph?
Q. If you want to look at it, it is tab 5 in bundle D. The main section of this, he starts at paragraph 16, "Activities and risks of companies supplying unbranded medicines". And the main paragraphs that I am thinking of now are 23 to 29 and he says in summary at paragraph 29:

"The activities and risks incurred by Flynn are typical of any other company supplying generic medicines."

I think you agree you did not have industry sector expertise. Do you have any reason to doubt what he is saying as a matter of sector-specific evidence?
A. No. I said quite clearly that I take the risks as they have been presented. I am not saying this is a risk-free business. Obviously it is not. But I did explain why I think that these risks do not appear to be high.
Q. I would like to go to your explanation now. You have dealt with this in more detail in your second report at paragraph 4.12. This is where you expand on your comments about the relative riskiness of Phenytoin compared to other generic products, and you say

Phenytoin in your view has relatively lower risks for various reasons. If we start with number one, and remembering what we are doing here, you are giving reasons why you do not think it is appropriate for the ROS rates of other comparator generic companies to be used as a comparator for Flynn, so remembering what we are doing here, you say at subparagraph (1):

"A new generic drug faces uncertainty about whether it will receive regulatory approval."

But given that the point we are testing here is looking at the ROS rates of other comparator generic companies, what we are doing is comparing Phenytoin with the profitability of drugs that have been approved and are on the market, are we not?

A. No, not quite. So this is where I say that I am able to interpret this. When the generic company launches, it faces a risk that it will not be approved, and because it faces that risk --

Q. Sorry, it cannot launch until it has been approved can it?

A. Before it launches it takes a risk, it has to make investments. It makes investments potentially in the manufacturing of the drug. So I think that in the CMA's document there is evidence that NRIM took six years and had costs to manufacture. So as an generic, if you are entering into a industry and there is a risk ultimately that you will not be approved, then you need to have a return on that investment in case it turns out that you did not gain regulatory approval. So you face an ex ante risk that the risk may occur, and because it may occur you demand a higher return and that return has to be recovered over the period after approval, obviously.

Q. So your point is that built in to the ROS rate of a generic company is an extra rate of return to take account of the risk that has not materialised, that the company that has been put on the market would not have got approval. Does that make sense?

A. I am not sure that summarises it quite. What I am saying is it is called an ex ante risk. In an ex ante risk of something not occurring, under the scenario where you do recover the -- where you do get regulatory approval, you earn a higher return. It is called a fair bet principle. Ofcom talks quite a lot about this, about products are about to launch, they need a higher return over their life, because there is a risk that the new product will fail. That is standard finance.

Q. So you say that the possibility of the product not being authorised should lead the company to charge a higher ROS -- get a higher ROS on the product that was actually

authorised?
A. Yes. In essence what somebody does when they make an investment, they will have a number of probabilities. They will have a probability that it is successful and they will have a probability that it is not successful. And they will run two sets of cashflows, they require a return on the combination of those two. Obviously we only observe ex post one of those scenarios, either failure or success. But in the success you do need to recover the cost and the chance that it may have been a failure and that is what I am saying is standard finance theory.
MR LOMAS: Would they run two sets of cashflows or would they have one cashflow and adjust the discount rate to take account of the risk of failure? Would it come to the same thing?
A. Yes. The purist would say you do not know what the fudge factor is, so you could adjust the discount rate, but how do you know how much you have to do it? So the cashflows gives you a little more specificity around how much that risk might be and that is, as I say, pretty standard in investment appraisal.
MS BACON: So are you saying that across a company's portfolio it will have to add some ROS to take account of the risks of products that it never got approval for?

A. That is standard finance theory.
Q. How is Flynn different from any other generic company in that respect?
A. Because in this instance it did not face that regulatory risk.
Q. Yes. But if you are saying that one does it across the portfolio, because of course you only do it in respect of the products that you have actually launched, then Flynn is exactly the same, is it not, because it has a risk that it might take on a product that does not get approval?
A. No, I think what we are saying is that the product, if you have a subset of products, some of them are going to fail and some are going to be successful. Of the ones which are successful, they have to recover the chance that that particular drug would have been unsuccessful.
Q. But you have to recover your investment across your portfolio, do you not?
A. But what I am saying is that that is built into every successful drug. Every successful drug has the chance that it may not have been successful.
Q. So there is a level of uncertainty, you are saying, in relation to every generic product? Is that not what Mr Davies was saying?
A. I am not sure. He is saying that there is regulatory

approval, there is an uncertainty in that, and I am saying that that is not an uncertainty that faced Phenytoin so it does not need a return that it would not have received regulatory approval. It already had it.

Q. Okay. So you say that when we look at other generic comparators, we cannot use those as a comparator for the ROS for Flynn because those generic comparators will have had some products that did not receive regulatory approval and, in order to compensate for that, they have to make an extra ROS?

A. I am saying that there are going to be businesses that run risks of not receiving regulatory approval, and therefore they will have higher risks compared to the specific risk profile of Phenytoin.

Q. So you say Flynn was not entitled to take that into account in relation to Phenytoin despite the fact that it also faces that kind of risk on other products, presumably?

A. But it would be recovering those risks through its other product already. So Phenytoin is a new product that comes into the marketplace, it already had a portfolio, it would have already been recovering that risk from its other products.

Q. And that is not a factor that one could take account of just by doing an adjustment up or down, like you suggest for the PPRS?

A. No, I think that you can. It is a qualitative factor. You would be saying this is a qualitative factor that takes you downwards rather than upwards.

Q. This is one of your reasons for dismissing generic comparators a priori, is it not?

A. I am saying it is likely there is going to be a set of generics that faced that risk which means that it is going to have a higher observed rate of return and you have to move downwards from that. My point is if you have already got a 6 per cent, you can move down from 6 per cent, you do not have to move down from the higher comparator.

Q. So you use that to dismiss the comparator.

Let us move on to subparagraph (2). This is a similar point, is it not:

"A new generic drug faces uncertainty about the market share it may win."

But you say that Flynn had reduced commercial risks because of the continuity of supply principle. In this case you know, do you not, that Flynn lost a large amount of market share to NRIM?

A. I know that it did, and I know that there are facts behind that --

Q. I am not going to ask you about that.

A. But I think there is a second point here. A new generic firm when it enters has no customers, so it faces a different risk profile of gaining some customers. Here Flynn already had a captive base and I think that is different. Starting with lots of customers versus starting with no customers is a different risk.
Q. And what we saw is that Flynn, on the product on which it competed with NRIM, had broadly the same volumes within a certain amount of time, did not we?
A. I know that it lost market share when there were issues with the continuity of supply.
Q. And you have not been asked to give evidence about the continuity of supply principle, have you? That is outside the scope of your evidence?
A. No, but it is a fact that I rely on in evaluating the risk.
Q. Do you agree that the point about competitive uncertainty is covered by Mr Davies in the paragraphs we were just looking at?
A. I seem to remember, yes.
Q. We do not need to go back to them. And you have agreed that you do not have industry-specific expertise to rebut his industry-specific evidence on that point?
A. As I said, I do not have industry expertise to develop what the entire set of risks are. Based on the facts

that I see, I am able to put a qualitative interpretation of whether that means a return should be higher or lower, as simple as that.

Q. Your subparagraph (3), you say halfway down:

"I consider it reasonable to assume that new generic versions of the drug would have less evidence on the benefits and side-effects which might influence product demand."

Do you know how a generic drug is approved?

A. No.

Q. So you do not know that the generic authorisation of a drug would be based on the safety and efficacy of the reference product?

A. That is true.

Q. What, you do not know it, or that you agree with my --

A. I agree with your proposition.

Q. So you therefore know that the whole point of a generic authorisation is that the generic company does not need to do its own safety and efficacy testing?

A. No, that is true, but I am responding to Mr Davies' evidence that there is a risk of these drugs having problems, and my only point is that it is less likely for Phenytoin as that has had a very long track record.

Q. I am just looking to your second sentence in paragraph 3:

"I consider it reasonable to assume that new generic versions of the drug would have less evidence on the benefits and side-effects which might influence product demand."

And you are comparing that with Phenytoin's track record. So if this is a point about generic comparators, what you are trying to say is that if there is a new generic version of something, there would be less evidence of benefits and side effects. And I am just saying if you have a generic product, by definition you do not have to do your own safety and efficacy testing because you have exactly the same safety and efficacy evidence as the reference product. That is how a generic drug is approved, is it not?

A. I think that is right. But as I am saying I am replying to Mr Davies' paragraph at 28 where he is talking about there can be serious adverse quality issues. And as I understand it, whilst that might be a risk for everyone, I understand that Pfizer has provided an indemnity to Flynn for those types of risks. And if that is true, if they have an indemnity, all other things being equal, that is a qualitative factor that means they would have less risk.

Q. You are not talking about the indemnity in this paragraph. Mr Davies is making a quite different point in paragraph 28. He is saying the company is responsible for the quality of the product and compliance with regulations. Those are risks borne by the marketing authorisation holder, and that is one of the points on which he says Phenytoin is exactly the same as other generics, and your response is to say new generic versions of the drug -- and I will come on in a minute to what you mean by "the drug", but new generic versions would have less evidence on benefits and side-effects which might influence product demand. Again, this lowers the competitive risk Phenytoin faces. Are you talking about NRIM there?

A. I think I am talking about generic drugs in general.

Q. So you are saying new generic versions of products will have less evidence of benefits and side-effects. How does that affect the validity of generic products as a comparator, which is what we are talking about here?

A. If it is factually true that they have less of a track record, that is obviously going to be in the minds of the people who are taking those drugs.

Q. I think you have just agreed that you do not need to have a track record because a generic is a copy of a reference product which does have the track record and has all the safety and efficacy data in the dossier?

A. That is outside of my expertise.

Q. So can we just put this point out the window?
A. It is outside my expertise, so I do not know.
Q. Paragraph 4 then:
"Pfizer suggests that the increase in the price of Phenytoin clearly created opportunities for generic entry."
You seem to be talking about generic versions of Phenytoin capsules here?
A. Yes.
Q. But Flynn has not used NRIM's capsules as a comparator, have they?
A. No, that is true.
Q. So if we just strike a line through subparagraphs (3) and (4). Then you are left with subparagraphs (1) and (2) and I have explored those with you. You are saying that uncertainty about regulatory approval and uncertainty about market share are the reasons why one can completely reject a generic comparator a priori?
A. No, it is not quite that. Because the decision also talks through a whole range of different risk factors. Mr Davies has concentrated on a subset of those. So my analysis is also based on that. It is not just about risk, it is also about level of investment, and various of the witnesses talk about other generics requiring investment. I have to go back to my conceptual

framework; that it is not just about risk and return, it is also about volume and the level of unit costs. So if I do not have information on all of those, then I have no basis on which to look at those comparators and say that they would be meaningful. They may be meaningful but I have no idea if they are.

If they all came in with a very narrow set of percentages, they were all at 21 per cent, then I would say that would be fair evidence. But they do not, there is a massive spread of percentages. Which means something must be driving profitability. It is either investment, it is either risk, it is either unit cost or it is volume and, if I do not have all of those dimensions, I cannot use them as a comparator.

Q. Or could this mean that the profitability of generic products just does not conform to your neat conceptual analysis?

A. In a competitive market I think businesses conform to the conceptual framework.

Q. But these are not perfectly competitive markets, are they?

A. I did not say "perfectly competitive", I said "competitive".

Q. So you have not done any analysis of the extent to which generic markets generally correspond to that framework?

You are just assuming, are not you?

A. The theory of finance is applicable everywhere. Finance theory is finance theory. In a sufficiently competitive market, competition constrains people to their cost of capital. If they are not -- and that is not to say you cannot earn above an average return. There may be temporary periods in which you do and, if you had some special advantage like lower costs, then you may be able to extract that from the marketplace as well. But the general view in competition economics is that, in the long-term, you would expect industries to conform with some kind of normal profit, assuming a competitive equilibrium. If there are drugs out there that have high returns, then it might not be in a competitive market but remember one of the issues here is that the problem with the return on sales figure is that it is biased by this issue of volumes and unit costs. So you cannot quite simply look at a return of say 20 per cent and say that is applicable --

Q. Mr Harman, I am going to come to that. I am going to come to that.

A. That is an important point though.

Q. Can I take you back to paragraph 4.73 of your first report. These are some more reasons why you do not think generic comparators are relevant. This is to some

extent submissions, but I note that in the subparagraphs of 4.73 you refer to various differences in the comparators that have been put forward, such as the fact that some of the companies in the sample sets have UK manufacturing?
A. Yes.
Q. One of companies has a portfolio that includes patented products?
A. Yes.
Q. Some of the proposed comparator companies engage in product development?
A. Correct.
Q. Did you carry out an analysis of the extent to which any of those factors applied to the branded products covered by the PPRS?
A. We know that under the PPRS the manufacturing is unlikely to be an issue because that is going to be a foreign subsidiary taking advantage of the transfer price. If it did include it, then that would mean that it had a higher return, and we are saying it should be lower than that higher return. So I think that it is also true that we know that the PPRS includes patented and innovative drugs. So we know that. And if you are not patented, which allows you to earn a supernormal profit for a period of time once you are under the

protection of the patent, we know that it is likely that Flynn will have a lower return because it is not patent-protected and we do know that there is obviously going to be research and development, because the PPRS scheme allows for research and development.

So I think it is fair to say that these factors allow us, on a qualitative assessment, to believe that the return should be lower than the average. I cannot say how much lower than the average, but I think that it is a fair assumption.

Q. I was just asking you whether you had analysed whether those applied to branded products and you said that at least for patents and product development that is something that would apply under the PPRS. But you have put this forward here as a reason for rejecting the comparison. Does it not also stand to reason that, if this is a reason for rejecting the comparison with generic companies, it should also have been a reason for rejecting the comparison with the PPRS?

A. No, I think it is a slightly more nuanced point than that. If I have two comparators, one is 6 per cent, and let us say that we look at generics and they are 10 per cent, if we do an analysis, qualitative analysis, that says: do I believe the risk is lower than these two benchmarks, and we assume in my scenario here that they are less than, I do not need to consider the generics because I already have a lower benchmark and I know that it is going to be lower from that benchmark. The problem with taking the generic benchmark is how far lower do you go. I think that the PPRS scheme gives us potentially an anchor point to say: I am not going to start at the generics and go lower, I am going to start at the PPRS and go lower. I think that is the difference.

Q. But was it not that, if you had started with the generics and gone lower, you would have been starting at a much higher starting point?

A. But this is my point. I say that, when I look at the ROS percentage analysis that has been presented by Mr Davies and Mr Williams and CMA, I see that there is a fantastic dispersion of results. There are clearly results that are below 6 per cent and there are clearly results which are very high. The problem is: how far lower do you go, given that dispersion.

Q. How many results below 6 per cent did you see in Mr Williams' and Mr Davies' comparators?

A. Just off the top of my head, for Mr Davies I think three.

Q. And average rates?

A. The average rates, as I have explained, are highly dependent on the level of volumes and unit costs.

Q. But you did not do that for the PPRS, did you? You did not say the PPRS ROS was dependent on volumes and unit costs, you are using an average. So why can you not use a generic average?

A. Because what we are saying here is that we know that Phenytoin has a profile that is high unit costs and high volumes. Qualitatively that takes me lower than the 6 per cent. The problem is, if I am dealing with generics that have low unit costs and low volumes, then that is going to inflate the ROS too far away, because it is being influenced by these two critical factors.

Q. You do not know that the generics do have low unit costs and low volumes, do you? You are making an assumption that you have not tested because you have not looked at the portfolios of those companies?

A. We have tested Flynn and we can see on Flynn's analysis, when we control for unit costs and we control for volumes, Phenytoin is a complete outlier.

Q. I am going to come to your outlier analysis. I am sticking with the ROS benchmark. We have not finished with that point. I am asking you why, if you have so many concerns about comparability that you dismiss the generic as starting point, you then do not apply any of those concerns to PPRS. But you have given your answer and the tribunal has heard it. Can we move on to paragraph 4.74.

PROFESSOR WATERSON: Just before we go there, just a terminological point. You sometimes say "I" and you sometimes say "we". When you say "we", do you mean you and people who have been working under your direction?

A. Correct.

PROFESSOR WATERSON: Thank you.

THE CHAIRMAN: Could I just ask something just before lunch. Ms Bacon is putting questions to you about whether you are right in your opinion not to regard what she and her client are putting forward as good comparators as good comparators. That is what this section of the cross-examination is all about. I think my impression from some of your answers is that one of the reasons you have not regarded them as good comparators is you do not have enough information about the characteristics of the company or the product that is being put forward as a comparator. Is that right?

A. That is correct.

THE CHAIRMAN: You are obviously giving evidence as an expert after the event.

A. Yes.

THE CHAIRMAN: You did not take the decision. You are commenting on the decision --

A. Correct.
THE CHAIRMAN: -- and how we should view the situation now. I have to confess when people say "I do not have enough information" my initial reaction usually is to say: "well, why do you not go and get the information and then you will be able to say I have looked at the full characteristics and they are not comparable." Would you regard that as a more satisfactory position to take, rather than ruling out going down the comparator route in respect of those products because you do not have enough information.
A. Yes, I think that is a fair point. I think I have a few responses to that. I think the first point was a matter of instruction; that I am looking at the evidence after the decision has been made and after the appellants have given evidence, and my instruction is to look at what has been presented and see whether I think there is information in there that would disagree with the 6 per cent. So that is a matter of instruction. I am not taking that as any protection --
THE CHAIRMAN: No, I understand that point.
A. I am not taking any protection from it.
THE CHAIRMAN: And you are not under attack, Mr Harman. I am just trying to put this point to you.
A. But my second point is that I find, in my experience,

doing robust comparator research very, very difficult. I have just done something down in South Africa on the private healthcare inquiry down there where they looked at hospitals globally, and the problem is that as soon as you get into -- and we had much more information than we do here, the degrees of comparability are so immense that nothing meaningful could come from it, and we spent a lot of time trying to do this. It is genuinely very difficult to (a) get the information. Because what would it require? It would require me to go to one of these companies and say: I want information on all of your products, all of your costs, I want to understand the risk profiles, and it becomes fantastically difficult.

So to answer the question, I think it is very difficult to do. I think that if I set out to do it, I would probably come up with "these companies are not comparable", and, if that was the case, I would try to alight on other types of profitability percentage information that might tell me something about the overall level of return. What can be done more easily is a return on capital employed approach, which is a cross-check that I applied and I do think that that provides some additional information here that is slightly more robust than --

THE CHAIRMAN: I was not getting into the merits of your evidence. I was just exploring that question. So I suppose it could be said that maybe the competition authority might be in a better position to obtain that sort of information that you say is difficult and frustrating to try and get.

A. I think it would have been possible. I do not know from a logistics perspective how the CMA could have done it. I think that is a reasonable statement. But I would also say that the experts on the other side who have much more detailed knowledge could have provided one or two additional points that might have assisted. So in my first report and in my second report, which were replied to, I said the problem with my analysis of the generics is that I have no information on the types of drugs, investment and risk profiles and I think, if an industry expert had said something more definitively on the portfolio, that might have been of assistance to the tribunal.

THE CHAIRMAN: I think we might pause and come back at 2 o'clock.

(1.04 pm)

(The short adjournment)

(2.00 pm)

MS BACON: Mr Harman, we were just coming to the end of the

section of my questions on generic comparators and
I wanted to cover off a couple of last points with you
on that.
Can you take up your first report and look at
paragraph 4.74.
A. Yes.
Q. Your point in that paragraph, as I understand it, is
that companies might not account for the measurement of
costs in the same way?
A. Yes.
Q. The one example you give is how companies value stock?
A. Yes.
Q. Have you reviewed the accounting policies in the
published accounts of the various comparators to assess
if there is a difference?
A. No, I have not.
Q. Have you calculated how much of a difference different
methods of valuing stock might make to a calculation of
return on sales?
A. In this context, no.
Q. Would you accept that even if there are different
valuation methods, the effect on operating profit over
the year would most likely be irrelevant as long as they
had consistent stock valuation qualities at each
year-end?

A. I am not sure that necessarily follows. I would need to see the empirical evidence to see if that was the case.
Q. My point is would not it just come out in the wash? As long as you adopted the same methodology throughout year-on-year, then --
A. No, I think --
Q. -- you would not see a material difference?
A. I think the simple point I am making is let us say there were just two comparators and they had different stock valuation methodologies, those stock valuation methodologies would produce different values, we are measuring stock at year end and this is a balance sheet item, it is not a movement between the period. If there were different stock valuation methodologies, which I know that there are, then that would bias the results. It is not a major point, the point about standardisation of accounting data, I would say the bigger point is when you start to look at gross profits versus direct costs because where you account for costs in that mix really does matter.
Q. Have you made any attempt to ascertain whether those concerns might also apply for companies that submit AFRs under the PPRS, or indeed any companies under the PPRS?
A. No, I have not. But the PPRS is a very large data set, so if you are looking at stock valuations over a larger

data set then to some extent these things all average out.
Q. So if you take a sample of more than one and just look at a bunch, then the more grapes you have in the bunch the more even the bunch is going to be, is that your point?
A. Yes.
Q. Whatever your various concerns about the generic comparators, and we have looked at those, is it your evidence that a comparison with the ROS rates of generic companies is completely uninformative to the CMA's analysis?
A. Yes, I think because of the distribution of results that we see from quite low to very high, then I have a concern that there is something that is driving those returns which means that the average is not necessarily going to be comparable. If you are below the average on your risk investment then observing average is not going to tell you anything.
Q. So your main concern is that because of the observed variation, you think that there is something in that that is driving the variation but you do not know what it is?
A. It is one of four factors. There's level of risk, level of investment, level of unit costs and level of volume.

Q. Or it could just be that generic comparators do not conform to your analysis?
A. It is true that if there was a niche comparator, Mr Davies talks about niche comparators in his report. If there are barriers to entry and you are a niche then you may have very high profitability. I do not think that would necessarily be a good comparator because of barriers to entry, and this is what we are trying to abstract away from, what is a return in a competitive market.
Q. And in the PPRS, have you done any analysis of the range of ROS rates within a PPRS?
A. No, I do not have access to that data.
Q. So it could be the case that actually exactly the same is true of a company that is filing an AFR, that some of its products will be very profitable and some will be less profitable?
A. I think that is exactly the point that is made in my report. It is likely there is a range around the average, and when we do our qualitative risk analysis, what we believe, that is FTI, is that the return is lower than the average.
Q. So it is okay for there to be a range in the PPRS because you look at the average, but it is not okay for there to be a range in generics because ...?

A. Because of the point that I made this morning. If the generic benchmark is above the branded benchmark, and you believe that on a qualitative assessment that it is below both of those, it follows that it is going to be below the branded. So you only need to look at the branded if you believe the risk investment return profile leads you to a conclusion that it is less than 6 per cent.

Q. Or it could be one of two things: that the generic return is generally above the branded, or it could be that the branded is not 6 per cent?

A. In respect of the first, I am not sure that is the case. Mr Ridyard presents evidence that he believes that generic profitability is likely to be below, Mr Davies does an analysis where he says they are likely to be the same, and Mr Williams makes an assertion that generics is likely to be above.

I started this morning by saying I have no belief beforehand that branded is likely to be more or less profitable than generic on a like-for-like basis. You will have high profitability branded goods and you will have low branded goods and you will have low generic and high generic.

It is an empirical question, but if it holds that the risk investment profile for Phenytoin is less than the PPRS benchmark, then I do not need to go to look at generics because I have already started from the right starting point.

Q. So it is an empirical question but that is not the empirical analysis that you have done, is it, because you said you did not do an empirical analysis?

A. We start from when we are looking at the PPRS and we do an assessment on a qualitative basis, whether it is likely to be below or above.

Q. Can I go to your ROCE cross-check. I will pick this up starting off with your first report at paragraph 4.7, then we will look at the second report.

A. First report, 4.7, did you say?

Q. Yes.

A. Is that the right reference, 4.7?

Q. 4.7:

"From this it is possible to test ..."

A. Sorry?

Q. 4.7.

A. Yes.

Q. What I think you are saying here is that looking at ROCE is one approach that could be adopted to test for excessive pricing?

A. Yes.

Q. Over the page, 4.8, I think what you are saying is that the competition test for excessive prices considers whether the ROCE equals or exceeds the WACC?

A. Yes.

Q. In footnote 84 you say:

"If a firm's profitability is higher than that which would prevail in a competitive market which is given by the WACC, that might indicate that prices are excessive."

A. Yes.

Q. So you seem to be suggesting here that the prices that would prevail in a competitive market are indeed those given by the WACC, that is your parenthesis?

A. Yes.

Q. Have you done any analysis of the extent to which profit returns in pharmaceutical markets are influenced by a company's WACC?

A. I am not sure I follow.

Q. Have you analysed whether the WACC that you use here, which is the 8.2 to 12 per cent, corresponds to a WACC that one would expect if you look empirically at returns in pharmaceutical markets?

A. This is based on Pfizer's WACC.

Q. Have you looked at whether that WACC is the WACC that would be used in other pharmaceutical markets in generics, for example?

A. As I said, we have taken a range from 8 to 12 per cent weighted average cost of capital. That is significantly above a regulated weighted average cost of capital. Based on my experience, for the generic to have a significantly higher WACC it would have to have a very high beta, and observing those betas is relatively rare. So my professional experience is that the WACC that we have used of 8 to 12, especially the 12 per cent, is likely to be generous, but I have not done an analysis of generic WACCs for sure.
Q. Are you aware that the PPRS has a ROCE allowance as an alternative to the ROS allowance?
A. Yes.
Q. Do you recall what that allowance is?
A. 20 per cent?
Q. 21.
A. 21.
Q. So with a margin of tolerance that is 31.5.
A. That is an average rate, and what we have observed is Pfizer's rate, and as I have been explaining it is quite possible for a company to have a return that is below the average.
Q. But that is the benchmark in the PPRS.
A. That is, but I am not applying the PPRS here, I am applying --

Q. That is a bit odd, is it not, because you considered that the PPRS was an appropriate benchmark for the ROS, and Mr Williams has explained that the ROS benchmark and the PPRS was calculated to be related to the WACC benchmark or the ROCE benchmark. So given that you used the 6 per cent in the PPRS as your starting rate for the ROS, why did you not take the PPRS ROCE figure?
A. Because what we are actually observing is the actual weighted average cost of capital for Pfizer who has drugs within the PPRS. I think that is a more empirical analysis of what the risk facing Pfizer is. The actual risk that it faces.
Q. But you say you did not do that for generic companies or Flynn?
A. No, but I would be surprised if it was significantly higher.
Q. You do your ROCE analysis at paragraphs I think 4.25 onwards. That is headed "My Assessment of the CMA's ROS Findings for Flynn"?
A. Yes.
Q. You say at 4.26:

"That approach provides an indication of the minimum return investors would require on invested capital."

A. Correct.
Q. But you then go on to conclude at 4.32 over the page,

last sentence:

"The ROCE analysis corroborates the conclusion that a 6 per cent ROS is a reasonable return for Phenytoin."

A. Yes.

Q. And you say the same at 4.37?

A. Yes.

Q. So in those later paragraphs, you are not saying that 6 per cent is sufficient return on invested capital, you are saying the ROCE analysis is one reason why it was reasonable. Full stop.

A. Sorry, I missed the end part.

Q. You started off talking about an indication of the minimum return?

A. Yes.

Q. Then you used that analysis, which you said was a minimum return analysis, to corroborate 6 per cent, so you seem to be turning it into a maximum?

A. No, I am not at all. If you look at figure 4.1, this is the output of the WACC analysis, the ROCE analysis on page 49. I have looked at four different measures of working capital. I have to say that in each of these measures from different sources I have been conservative because I do not include creditors in the analysis. Creditors is a liability that would reduce these figures. Obviously if you buy stock and you have not paid for it, then you have not really invested anything.

So these are conservative estimates. And the thickness of the bar is because I have used a wide range for the WACC that I explained, 8 to 12. I think 12 is a relatively high rate, and what you can see on the right-hand side is what this analysis turns into on a return on sales basis. The highest is about 3 per cent and the lowest is below 2.

So I say that it is a minimum because the answer is coming out of 2 per cent, but I am saying that 6 per cent appears reasonable because there is a margin -- headroom, if you like -- of times 2 to times 3 from that analysis. So I am giving them at the one end three times more return than they require and at the higher end two times more. So effectively I am saying that it starts from a minimum and because it is below the 6 per cent, the 6 per cent appears reasonable based on a test that looks at the minimum.

Q. Do you not get those figures because you have used a WACC that is way below, in fact about a third as much of the WACC that under the PPRS is regarded as the reasonable WACC?

A. Well, it says "return on capital". I am not sure whether that is the return on equity or the return on debt and equity, that would need to be confirmed, but

that is the average rate. I based this analysis on what Pfizer's actual weighted average cost of capital is, it is an empirical measure of what the market will lend money to these customers. That is why it is the minimum.
Q. That is the only empirical analysis that you have done, is it not?
A. It is, but it is relevant because we calculate the WACC when Phenytoin was within Pfizer.
Q. So it is okay to do an empirical analysis if that results in something that is three times below the WACC that is given in the PPRS, but on the other hand when you use the ROS figure, because 6 per cent is a nice low figure, it is okay to use that benchmark and not do an empirical analysis?
A. No, that is generous. By selecting 6 per cent that is generous. This is testing the minimum amount that you require, I am not testing the maximum here.
Q. So CRA, as you will have seen, they have objected to your ROCE analysis, that is Mr de Coninck's report?
A. Yes.
Q. And he makes various points. The first is that a ROCE analysis is inappropriate for cases where the capital employed is hard to value or in asset-light businesses. His second point is that, even leaving that aside,

a comparison between the ROCE and WACC is not informative of whether profits are actually excessive because the WACC is just the minimum level, I think you are now saying that you agree that it is a minimum level?

A. So taking those two points. Do not forget I have been asked to look at a reasonable rate of return for the purposes of the first step of United Brands. I am not testing the rate above which things become excessive, so it is just a return rate of return. I fully accept that returns can deviate around that but that is a second step which I have not been asked to look at.

That was an answer to the second question. Could you just remind me of the first?

Q. I was not actually asking you about the first, I was more asking you about the second of the two, because you do agree there are difficulties associated with the ROCE-based approach for asset-light businesses, so I was not going to ask you --

A. It is important to understand the motivation, why I did the case, because it was advanced that Phenytoin needed a high return because it had high stock values that cost a lot of money. So the purpose of this analysis is to test that proposition, and I find that its high return is not due to the level of working capital it requires.

So the point about capital-light businesses is that it is right that working capital may not provide sufficient capital. There are businesses where there is more going on that you have to give a return on, so brand values might be an example, or where there is contingent capital. This is very prevalent in things like the energy markets where you had very low capital employed but the energy companies had to purchase gas and electricity in advance of knowing how the weather would turn out. If they got that wrong the business could make very substantial losses. So the industry argued that you would need to have some "risk adjusted" capital on the balance sheet to protect you from those losses if a one-in-five winter came along.

So it is true that when you do this type of analysis in asset-light, you have to be cautious that there may be assets not on the balance sheet that you have to give some credit for.

In my first report I raised the question saying: this is the case, I have looked at it on this basis, and there may be more capital. But nobody has responded to that to say, ah, you are missing this type of capital. In fact in CRA's final report it argues that there is no other fixed capital.

Q. I think that is a matter for Mr Hoskins' submissions.

Can I just --

A. But I would just like to make the relevant point around that. Just to come back to --

THE CHAIRMAN: Stick to the questions for the moment, if you would not mind.

MS BACON: Can I then ask you to look at your second report, paragraph 4.32, the last sentence:

"I used ROCE only to check that 6 per cent is sufficient to meet Flynn's working capital requirements."

Then you have also said at 4.30:

"The ROCE cross-check ensures that the ROS is not set at a level that is obviously too low."

Am I right to understand from this that all you are doing with your ROCE analysis is confirming that, taking your WACC of 8 to 12, Flynn's profitability is above the minimum floor that investors would require?

A. That is the first step of it, yes. The second test that I do, which is on the next page, is to say what happens if instead of just the working capital you have to recover some form of notional capital on top of that? Because in effect if you need a return above notional capital, above variable capital, there must be some form of notional capital, brand value or something to that effect. And that is what I test in 4.34 by saying if

I take the full capital of Flynn and apply that to each product, ie giving each business its working capital plus some form of notional capital, what does the return on capital employed look like?

I am using this as a further cross-check to try and see if Phenytoin is different, and what the graph shows is that Phenytoin is very different from all of the other products. But even if it recovers all the capital of Flynn it earns a weighted average cost of capital of [percentage redacted]. No other product, even high volume products like [product redacted], comes anywhere close.

So this analysis is also used to corroborate my analysis of CRA's analysis of Flynn's profitability across the products.

Q. That is a different topic to which we are going to come tomorrow, Mr Harman. So just sticking with the question that I was asking, about your conclusion in 4.32 --

PROFESSOR WATERSON: You mentioned a figure there earlier. I am not sure whether that figure should be revealed openly.

MS BACON: I am sorry, actually that is right. And there was mention of a few products there which need to get removed from the transcript as well. I will get our solicitors to liaise with the transcribers afterwards to make sure that a suitably redacted version is prepared.

So in your analysis at 4.30 to 4.32, because you agreed that you were using that to set a floor rather than a ceiling, do you agree that that analysis in itself does not tell you whether 6 per cent is right or not? And sticking with the question about the ROS benchmark here, not talking about other products.

A. It does not confirm that 6 per cent is right, ie too high, but it does confirm that it is not too low, which is also an important point because I was responding to an argument that says we need high profitability because we have high working capital and that turned out not to be the case.

Q. You confirm it is not too low from the perspective of an investor return, but that does not tell you whether it is too low for other reasons, for example, because it is very far below the profitability range for generic products as a whole?

A. I am not sure you can say that from a consistent generic point, ie you could say on the generics that you have put forward, but I cannot say whether they are like-for-like comparables.

Q. My point is you were using the WACC to test from a particular perspective, from an investor perspective, whether the 6 is too low, and you say from an investor perspective it is not too low, but that does not mean there might not be other reasons why it is too low?

A. I am not sure I follow, sorry.

Q. The point is simply that there may be a variety of reasons why one would set a profitability level at a particular point. You are saying that the benchmark of 6 is not too low if you are purely looking at what an investor would require, and I am saying there may be other reasons, other than simply looking at the minimum an investor would require, which might indicate that profitability should be higher or at least the benchmark should be higher?

A. That might be the case, but finance theory would tell us that the investment community would invest at that rate in this type of product. That is what market theory tells us. So companies may earn more than that, but actually if this opportunity presented itself to investment banks they would invest at that rate of return and earn quite a healthy profit from it.

Q. Can I turn to the margin of tolerance now. That I think is the last section in relation to the ROS benchmark.

At paragraph 4.55 of your first report, you say that the parties' arguments regarding the MOT conflate the two questions of what constitutes a normal return and what is an acceptable deviation from the benchmark.

A. Sorry, am I at ...
Q. 4.55.
A. Yes, I see that.
Q. Is it correct to say that you accept that under the 2014 PPRS, a local return of up to 9 per cent is acceptable?
A. Yes.
Q. So put another way, you accept that the 9 per cent is the allowable return under the 2014 PPRS?
A. It is not the way that I have interpreted it. What I interpret from the scheme is that you are allowed a 6 per cent return with a margin of tolerance of up to 9 per cent. But as soon as you get to 9 per cent then you are in contravention of the scheme. So the way in which I have interpreted it here is that a reasonable rate of return is 6, but it could be higher, up to the margin of tolerance. But the difference between the 6 and 9 there I am seeing as a part two of United Brands as opposed to part one, so that is the difference.
Q. I was asking you whether acceptable means allowable. The point is under the PPRS, 9 per cent at the moment is allowable, is it not?
A. It is, but --
Q. That is all I wanted --
A. -- you go a penny over and then you are in contravention.

Q. Yes, but I am not disputing that. I am not asking about the contravention range.
And do you accept that the allowable rate under the old PPRS was 8.4 per cent?
A. I do.
Q. You say that looking at what is the allowable return is the wrong question because the question should be normal return?
A. A reasonable return, yes.
Q. You say "normal" return here.
A. Okay, I mean "reasonable".
Q. So we strike out "normal" and put "reasonable"?
A. Well, I define reasonable return at the beginning of section 4 and I also, in that definition, refer to it as being normal. So I have already defined reasonable and normal as being the same in an economic sense.
Q. So you think it is the same thing. So you mean reasonable or normal under the PPRS.
So you are saying then that the benchmark should be the reasonable/normal return under the PPRS, not the allowable return?
A. For step one of United Brands, yes.
Q. So when the CMA in the decision referred to the allowable ROS, and I have taken you to the paragraph in the decision where it did so, are you saying the CMA was

referring to the wrong thing? Should it have been referring to the normal or reasonable ROS under the PPRS?
A. I am not sure.
Q. What do you say is the normal or reasonable ROS? Is that the 6 per cent?
A. Yes.
Q. But you have already said you do not know what a company in the PPRS actually makes. So you cannot really say that that is normal/reasonable, can you?
A. I am saying 6 per cent is an agreed target, which is a target. You should be allowed to have 6 per cent.
Q. I have already asked you if you know how many companies make that 6 per cent and you said you did not know.
A. No, but there is some evidence in Williams 2 that might assist us on that.
Q. But do not know. You have not done any analysis. You do not know if companies actually make 6, 9, 20 or 50?
A. Well, I do, because in Williams 2 he says that after all of the adjustments have been made, the return, out-turn returns, are circa 19 per cent.
Q. Yes. I was not asking you what the returns are after all the adjustments have been made, I was asking you what the returns are just looking at the return that the company makes, not what it plugs into the AFR --

A. But you have already explained that that is the wrong column. We should not be looking at the company return, we should be looking at the adjusted. When we look at the integrated adjustment of 19 per cent we know that what has been stripped out of that is the profitability of the foreign entity. So to put this on a like-for-like basis we have to take 13 per cent off that 19 per cent which gives us a return of 6 per cent or below. So actually what Mr Williams' analysis suggests is that firms are actually earning around 6 per cent, not the 9 per cent which does actually confirm this as a target.

Q. I am not asking you what Mr Williams said, I am asking you what you have done. And the point is that you do not know, looking at any of the statutory accounts for any company within the PPRS, except for maybe Flynn and Pfizer, you do not know what they make?

A. I have not done that analysis because Mr Williams has done that analysis.

MS BACON: I do not have any more questions on the ROS benchmark so I was then proposing to move on to cost allocation, but I promised to pause and allow any questions that there might be so maybe that is a good moment.

PROFESSOR WATERSON: I was looking for the reference, but

I cannot at the moment lay my hands on it, where you talk about what an excess return would be versus a reasonable return.

A. Yes.

PROFESSOR WATERSON: I am afraid I cannot find --

A. Where I define reasonable return? I think it is at the beginning of section 4 of my first report. It is paragraph 4.5. Basically it says:

"The OFT has explained that in a competitive market --"

PROFESSOR WATERSON: Yes, thank you. So at 4.8, you say:

"The competition test for excessive prices considers whether the ROCE equals or exceeds the WACC as follows ..."

A. Correct.

PROFESSOR WATERSON: So the WACC is reasonable, is that right?

A. Yes, it is calculated based on the weighted average cost of capital, equity and debt. Debt is obviously actual debt, equity is based on normally the CAPM model. The CAPM model takes what the average market return is and adjusts it for risk.

PROFESSOR WATERSON: So as soon as you go over that WACC then it becomes excessive.

A. No. Sir, I think this is the important point. What we say is that the reasonable return is 6 per cent and there may be some variation around that. As an economist I cannot tell you what that variation is, I think that is a legal matter. Obviously there has to be some gap because there can be calculation errors and it might be reasonable for firms to, in the short-term, earn returns above the average. But I am not saying that a per cent over 6 per cent and you would be excessive in terms of 102 or chapter 2 definition of excessiveness, I think we are just saying the starting point is reasonable and it is for the tribunal to decide how much gap it becomes excessive.

PROFESSOR WATERSON: So when you say the "competition test" for this, it sort of implies that 6 per cent would be okay but 6.1 per cent would not be from the way you have written 4.8.

A. I do not mean it in that way at all.

PROFESSOR WATERSON: I see.

A. Because if you look at footnote 84, I say it only "might" indicate prices are excessive.

PROFESSOR WATERSON: Okay, right. I was just trying to establish exactly what you mean. Thank you.

MR LOMAS: I had one technical question which may have been picked up somewhere in the evidence but I do not think so.

In your cross-check based on the ROCE calculation you were taking a WACC for Pfizer of between 8 and 12 per cent.

A. Correct.

MR LOMAS: That is a WACC that applies to the company as a whole across its whole portfolio of activities and products.

A. Correct.

MR LOMAS: Is it logically appropriate to take that range and apply it to a single product? We have had a lot of debate about average versus an individual product, but it seemed to me that that was implicitly what you had done in that analysis.

A. It is very difficult empirically to divisionalise a beta.

MR LOMAS: You look for single project companies and things like that.

A. And they do not exist.

MR LOMAS: Exactly.

A. Whenever it is done it is done badly. So the starting point goes back to: do we believe that Phenytoin, sitting in Pfizer's portfolio, is likely to be riskier or less risky? I cannot tell you empirically how that will change things, but I think the logic qualitatively means that if it is less risky it is likely to have a beta that is lower than Pfizer's.

MR LOMAS: Thank you.

THE CHAIRMAN: Can I be absolutely clear about this margin of tolerance. You are placing that as something which goes into the calculation of whether a price is excessive, ie above the reasonable rate of return.

A. That is just the way I have interpreted it. There may be alternative ways.

THE CHAIRMAN: And you are not actually instructed to talk about that.

A. No. Correct.

THE CHAIRMAN: So we should not listen really.

MS BACON: Just to be clear, sir, I think that is common ground, that the margin of tolerance issue here is used as one of the arguments why the 6 per cent was the wrong figure and it goes to the ROS benchmark.

As you will recall, I also referred to that when I was talking about the transfer pricing model. But that all goes to the question of the ROS benchmark.

With the tribunal's permission I would then turn on to the costs allocation issue.

Your starting point, and that is at paragraph 3.10 of your first report, is to say that there is no uniquely correct approach to allocating common costs because there is no direct link between common costs and

levels of activity. So I think you would then agree
that no cost allocation methodology can be described as
"perfect"?
A. Correct.
Q. So then do you agree that the correct approach is to
consider the various methods of costs allocation that,
even if not perfect, are at least informative or
potentially informative to the CMA's analysis?
A. I think I agree with one proviso, and the one proviso is
that I think that it is important, when we assess what
that reasonable set of cost allocation methodologies is,
that there is no factor that knowingly biases the costs
in a way which would not be objective. So it is not
that all are possible, but there are some that may have
in-built biases which make them less attractive.
Q. So you say that if something is potentially biased then
you should chuck it out of the basket, but in all other
cases, even if the method is not a perfect one, you keep
it in the basket?
A. I do not think that it is fair to say that I chuck
things away. In my table 3.2 I have actually done all
of the methods --
Q. I am going to come to that. But I put to you that you
would consider the various methods that are at least
informative or potentially informative, and you said

when you are looking at what is reasonable to include, so what is reasonable to put in the basket, you should not have something that was biased. So I am saying: is bias something that means you chuck it out of the basket and you do not look at it at all, or is bias something that means you would put in the basket but you might give it less weight than the others?

A. I would probably give it less weight in the basket.

Q. The latter, okay. So when you were deciding which cost allocation methodology to put in your basket as being informative or potentially informative, do you agree that it is relevant to consider whether costs are allocated in the sector that you are looking at and, if so, how that allocation is done?

A. In certain instances it can be relevant, but it is on a case by case basis as to whether it is relevant. So I think in this instance -- maybe I should not pre-judge the question that is coming later.

THE CHAIRMAN: Wise.

MS BACON: So if companies in an industry always or almost always allocate costs in a certain way, would you agree that that is a good indication that the industry views that as the most meaningful way to allocate costs?

A. The allocation of costs has to have a purpose. So allocating costs for commercial purposes may be different from allocating costs in a competition inquiry or a regulatory price setting instance. So I think again it has to be context specific.

Q. But with that qualification, it would be relevant to look at how companies do allocate costs?

A. If in fact companies do allocate costs to individual products, yes.

Q. Because if you do not look at what is actually done, is there not a problem when you come to consider comparators? Because you might then be comparing the ROS of the product that is under investigation with the ROS in a comparator where that has been based on a different cost allocation?

A. No, I think you are conflating two points. I think the rate of return is set exogenously from how cost allocation is performed. So that is the first step, calculate the rate of return. And the second step is then to consider what is the allocation mechanism. I do not see those two going as hand-in-hand.

Q. But if you have a different cost allocation then you get a different rate of return, do not you?

A. You might get a different rate of return.

Q. So that is my point. If you are taking the ROS that you have calculated on one basis, and if you are comparing that with whatever comparator where the ROS might have

been calculated using a different cost allocation methodology, then you would not be comparing apples with apples, would you? I think you said you would be comparing apples with kumquats or something like that?
A. Again I know where the question is going --
Q. Is --
A. -- but I disagree with the proposition that will then follow. So I am going to say that as a general position, the rate of return is set exogenously. And the second question is then you have to think about what is the most appropriate cost allocation mechanism in this context.
Q. Right. If I start with your evidence about a volume approach?
A. Yes.
Q. You say this is not only informative but is the reasonable, and indeed the uniquely reasonable, approach in this case.
A. Sorry, where do I say "uniquely reasonable"?
Q. I am perhaps summarising. But you say the volume approach is the only approach being adopted in this case, is it not, because you have rejected a revenue approach?
A. I reject the revenue approach in this case because it has a bias.

Q. So you are saying in this case the volume approach is the uniquely reasonable one?
A. No. I think incremental, stand-alone, equal and adjusted EPMU all give us other bits of evidence.
Q. Is that because they all kind of come out with the answer that you want them to come out with?
A. I do not want this to come out with any answer. I have been asked as a independent expert.
Q. As you know, one of the points Mr Williams makes is to say that in his experience, companies in the pharmaceutical sector almost invariably use a revenue-based approach rather than a volume-based approach and that he has never seen a pack-based allocation used to apportion costs between different products in a portfolio or across different columns in an AFR.
    I just want to look at your response. I think the best place to pick that up is in paragraph 1.4 of the joint statement which is at the back of your evidence bundle.
A. Yes.
Q. You say, picking it up in the second of the subparagraphs in 1.4:
    "The fact that an allocation based on volumes or revenues does not take place during the normal course of

Flynn's business is not necessarily relevant."

Then you have referred back to your first statement where you say the same thing. In your first statement at the paragraphs you cite, and perhaps we ought to look at those. So in those paragraphs you have set out some of what Mr Walters' has said. For example, at 3.18 you quote his statement:

"It is not possible to set a forward-looking price for a drug ... where sales volumes can vary so significantly."

Can we look at the whole of Mr Walters' evidence on that? This is one of those occasions when we need to look beyond these two bundles we have been using. I need you to have bundle B, tab 4. That is the first statement of Mr Walters.

A. Yes.

Q. The paragraphs I want you to look at where this extract is taken from is paragraphs 60 to 64. I do not need you to read all of them, but do you accept that one of the main points that he makes in this section, which he repeats a couple of times, one of them is in paragraph 60, for example, is that the majority of Flynn's costs, and I think he means common costs there, are fixed costs, not product-specific variable costs?

A. Correct.

Q. Do you agree with that as a matter of principle from what you have seen of Flynn's costs, Flynn's common costs?
A. They are assumed to be, yes.
Q. Mr Walters is not an economist, but do you agree that putting this point in economic language, the point that he is making is that volumes of sales do not drive Flynn's common costs?
A. That is true. But nothing drives them, that is why they are common --
Q. Yes, I was going to come to this. So you agree then with his statement that Flynn's volumes are not a driver of common costs, and you say that common costs do not vary directly with volume or with revenue?
A. We are in agreement.
Q. So is it therefore your evidence that cost causality cannot be used to decide between a volume or a revenue approach in this case?
A. Not in the short-term. But there is a conceptual point, and the conceptual point is this: cost allocation normally takes place within a framework. The most common one is an activity-based costing framework where one goes to great lengths to try and work out what actually drives costs, and it is normally a level of what activity, it might be volume, it might be headcount

it might be the number of orders processed. There will be a rump of costs which are common and fixed and do not vary with activity, that is what we are dealing with here. Normally that pot could be bigger than it should be because you have not really done an ABC costing, so you just assume the costs within there are fixed, and that is the kind of position we are in here, an ABC costing review was not performed, but we will assume they are fixed.

My biggest point is conceptually. In the short-term it is true that these costs will not vary by activity, but in the long-term, as activity changes, they could change. And changing common costs in the longer-term as activity expands are more likely to be driven by a volumetric.

Price, which is the component that is attached to volume to turn out to be revenue, never drives costs. I cannot think of a common cost, a fixed common cost, that would ever be driven by the addition of price. I can see it in terms of volume but not price.

So theoretically within an ABC context, volume appears better, all else equal, than a revenue driver.

Q. So you are making a theoretical point here?

A. Yes.

Q. But you accept that empirically, and as a matter of the

evidence that Mr Walters has given, where that leads one is that cost causality is essentially neutral, it does not point in one direction or another?
A. In this case that is correct.
Q. So can I just take you then back to your joint statement at 1.4. So that is what you were saying in the paragraph that we were reading before we went to Mr Walters.
A. Yes.
Q. You are responding to Mr Williams and you have responded by saying, well, what Flynn does does not really point one way or the other. But Mr Williams' point was not just that Flynn does it, but that he has never seen it done this way ever in his professional career.
A. I think the point here, the underlying assertion, and this is why I was loathe to give an answer because I could see this coming, is that when we talk about business practice and the use of revenues, the evidence is nobody allocates to products. Full stop. So revenues are not used to drive costs to products, and nor are volumes. So both revenues and volumes both have that problem.
Where revenue is used is to allocate within a broad pot of costs, to a broad portfolio of products, is into the PPRS, but it is not product-specific. And because

this is controlling for excessiveness by saying you can have a 6 per cent return overall, then a revenue allocator is not a bad allocator if you are allocating it to a broad spectrum of products in a portfolio if you do not believe them to be excessive. But nobody is allocating to products on the basis of revenues and that is the thing I am at odds with Mr Williams on.

Q. Mr Williams' other point is that in general pharmaceutical products are not sufficiently homogeneous for a cost allocation to be based on the numbers of packs. And I first want to take you to the relevant passages of his evidence and I will then ask you some questions about your response to this.

So can we look at Mr Williams' third report and that is in bundle D.

A. Which tab?

Q. Sorry, that is at tab 13. He makes this point about homogeneity as a general point about the pharmaceutical industry, and you see that in paragraph 33. He gives the example of one of his clients that sells a product, an oral contraceptive alongside a novel oncology product, and you will have seen what he says about that. Then at paragraph 36 he gives a specific illustration from Flynn's portfolio where he points out that ten individual vials of -- I have to make sure I am not ...

Yes, ten individual vials of Vancomycin would, on your cost allocation methodology, attract ten times the common cost allocation of a single ten-pack presentation.

Then if you turn to the next tab, Williams 4, paragraphs 13 to 16, he makes the same points and he puts some numbers on this to show that your approach or the CMA's approach would lead to the amount of cost allocated to the contraceptive product being 700 times the cost allocated to the oncology product even if their revenues were identical and even if the gross margin on the oncology product was, as one would expect, higher than on the contraceptive product.

At paragraphs 15 and 16 he gives a further example of the problems of a volume-based method if the pack size changes, and he gives the example of a particular product that was sold as part of a two-box regime but is now able to be sold as a single box presentation because of a new strength, and he says if that occurred, the cost allocation would immediately change even if there was no material change in the actual common costs. And no impact on overall demand for the product or revenues received from the product as a whole. And you will have seen that Mr Walters makes essentially the same points and I will not take you back to those.

Can I now look at your response to that which is in the joint statement at paragraph 1.2. So you say in 1.2:

"GH considers Flynn's products are relatively homogeneous. This means that the products are sufficiently homogeneous such that the volume-based allocation will not lead to obviously biased results."

And then you say:

"It is an empirical question as to whether different volume methods will lead to materially different cost allocations across products and over time."

Are you then saying there it is an empirical question whether products are sufficiently homogeneous?

A. No, I think that in that trawl of paragraphs we have managed to conflate two different issues, one is the question of homogeneity and the second is what happens if pack volumes change. They are actually separate points.

The first point about homogeneity is there is no test if things are sufficiently homogeneic, the question is do you have a common volume metric, and I explained in my report there are instances when you do not even have a common basis of unit. I quote a Siemens example, but another one would be from the telecoms sector where maybe you are selling leased lines to business which vary by length, and you are selling pay TV which is based on the number of subscribers, and mobile phone units which are number of minutes consumed. There you do not even have any homogeneity over the sales unit which means you cannot use that approach.

Pretty much in every single industry you are going to have different products. If I was in a supermarket I have different products, I am not only selling bananas but I have canned food and everything is different. The question is: is there a starting point that you can allocate on that basis? It is not a central part of my argument, I just say: by the by, you have a common unit, and here in the drug industry you are selling a drug to a customer so there is some commonness.

In the cost stack it is only the fixed cost which has got something that is suffering from homogeneity because the variable cost, and you have got all of these different products which do have differences, that difference gets reflected in the variable costs --

Q. Can I just bring you back to my question, please?

A. Well, you were asking me about --

Q. No, I asked you a very discrete and a closed question. I was asking you about your first sentence of the second paragraph at 1.2, and you say there it is an empirical question. And I am just saying can I summarise that sentence as saying that it is an empirical question whether products are sufficiently homogeneous, and that is a "yes" or "no" answer?

A. Okay, no -- so I started by saying we had conflated two different issues.

Q. No, I am not asking you about the paragraphs of Mr Williams' and Mr Walters' statements that I have taken you to. I showed you that paragraph in order to put in context your response which I am taking you to and I am asking you: what do you mean in the first sentence of the second paragraph of your response?

A. But that sentence is not referring to homogeneity, because if you read the full sentence in brackets it says "as pack sizes change". So that is the second issue. One is about homogeneity and the second is what happens if pack sizes change. So they are different points.

Q. But do you say it is an empirical question, ie you look at the specific products to test whether they are sufficiently homogeneous?

A. No, I am saying that the empirical test is what happens when pack sizes change. Because what is being put forward is that you cannot use volumes partly because of homogeneity, and I say they are sufficiently homogeneic. The second point they are raising is that you cannot use

it because if pack sizes change the cost allocations change.
Q. Right --
A. And I say but that is a natural point. If volumes change, cost allocation will change. If prices change, cost allocation will change.
Q. So you are saying it is not an empirical question whether two products or a group of products are sufficiently homogeneous?
A. No.
Q. How do you tell whether they are sufficiently homogeneous without looking at them?
A. As I said, as I was explaining, they have to have a common sales unit. The non-homogeneity part of it is picked up in the variable costs if there are differences in the drug, and because differences in products does not drive or change common costs. As long as they have a common unit you can use the volume-based method.
Q. Are you saying, therefore, it is sufficiently homogeneous if two products are sold in a sales unit of a pack because it is a common sales unit?
A. In my opinion I think that is sufficient.
Q. So a pack of Smarties is sufficiently homogeneous to a pack of Phenytoin capsules then?
A. But Flynn is not selling Smarties, it is selling drugs

in unit sizes, and those unit sizes must have some commercial logic behind them.

THE CHAIRMAN: I think you may not agree with what the witness is saying, Ms Bacon, but it is fairly clear what he is saying.

PROFESSOR WATERSON: Can I raise a point on this?

MS BACON: I was just trying to test the boundaries of the proposition.

THE CHAIRMAN: I know, you were trying to set the context for a question but you got a different answer.

PROFESSOR WATERSON: I am curious about this question about relatively homogeneous. Clearly if some things are measured in minutes and others are measured in an entirely different way then they are not sufficiently homogeneous. But it occurs to me that often in merger cases, for example, a decision has to be made as to whether two products are sufficiently homogeneous for them to be in the same market, for example, and there are essentially tests one can do.

A. Yes, we are not talking about it in those terms. We are saying does it make economic sense to be able to allocate a cost to one type of drug which sells in a pack that is a certain size to another drug that is in another kind of pack? It does not matter what is in there; it has a physical dimension, it goes through

a process of being sold, and I am saying that that sales process, the market you are selling into, its physical dimensions, that you have to order it, you have to sell it, are all sufficiently homogeneous to make sense of allocating a bunch of common costs to it. That is all.
PROFESSOR WATERSON: So this is a judgment, essentially.
A. It is a judgment.
MS BACON: Just picking up on that, did you look at all the different products within Flynn's portfolio to see what they were and why you thought they were sufficiently homogeneous?
A. I have looked at maybe it is Mr Walters' second witness statement, I think he has a schedule at the back that shows that there is a range of products, many of them sell in relatively the same pack sizes, there are a few that are outliers, I have observed that, yes.
THE CHAIRMAN: You were not here at the beginning of the hearing when Mr Brealey produced lots of different products?
MS BACON: He has them there, I think.
THE CHAIRMAN: I am not suggesting you bring them out!
I doubt that you had this aspect in mind when you ...
MS BACON: So is it your evidence that whatever Flynn sells, as long as it puts it in a pack, then it is sufficiently homogeneous?

A. For the allocation of common costs. Common costs are a small element of the total cost stack.
Q. Alright, but I am asking about common costs.
A. Yes, and I think because common costs are relatively small, and volumes are high across all products, that gives rise to a small allocation of common costs per unit, that to me seems sensible.
You will always find examples where you say: what about this product? But that is the nature of common costs. Whatever driver you use you will always find something that looks odd. The question is when you do the allocation does it look like a reasonable allocation to a particular product?
Q. So on that basis it does not even have to be a drug that Flynn puts in the pack; as long as it puts something in the pack then it is reasonable to allocate costs, based on that methodology?
A. As I said, Flynn sells drugs of certain pack sizes, many of them the same, there is a commercial logic in the way in which it packages drugs, and if those change then the allocations change and that is fine.
THE CHAIRMAN: I think if it supplied pay TV as part of its business that would not be sufficiently homogeneous.
MS BACON: Yes, possibly. Do you know what Collaguard is?
A. I know it only sells [figure redacted] packs.

Q. Do you know that it is a medical device?
A. Yes. Well, I will take your word for it.
Q. But you did not know before?
A. I know that [figure redacted] units of it are sold. [figure redacted] is so small it does not matter how I change the allocation of costs to [product redacted], it is not going to change the cost to other products.
Q. I think we also ought to redact the transcript on that basis because I am pretty sure that is a confidential number as well.
MR HOSKINS: I think it is not really fair, because the witness has been giving evidence in open court and should not be constrained from doing so. So I think it behoves counsel rather than Mr Harman. He should be able to speak freely.
MS BACON: I alerted the tribunal and everyone at the start to the fact that we need to avoid revealing confidential information. I am making no criticism, but I think we need to go back and deal with that on the transcript.
You have said that you do not look at homogeneity by doing an empirical analysis other than the broadbrush approach that you have just set out, and your point is that if Flynn sells a medical device, or indeed on your analysis presumably if it sold a sticking plaster or something like that, as long as it is in a pack then

that is sufficient?

A. That is not quite what I said. I said that you would adopt a costs allocation, you would look how it allocates, and then you would stand back and say is that reasonable?

Q. Right, so can we look at how that allocates now. What we have is a comparison between the results of looking at Flynn's portfolio with a revenue-based allocation and a pack volume-based allocation. We now have that in some of the revised figures that CRA has produced.

Can I start with CRA 2. Bundle D2, page 24, figure 7. Can I remind you the contents of this figure are confidential so we cannot say individual product names or percentages. I am trying to conduct this cross-examination in open court and I hope that we can, between ourselves, enable us to continue to do so because I do not want to have to keep going in and out of camera.

So this is the product contribution figure. Do you see here that all of Flynn's products make a positive product contribution?

A. A product contribution. Yes, I can see that.

THE CHAIRMAN: Can I be clear about this. If the percentage bars are anonymised is that confidential information?

MS BACON: I am being told if you do not link the names to the percentages that is not a problem, neither would it be a problem to read out the names, but it is the linking of the two that is the problem.

THE CHAIRMAN: The percentages are more interesting than the names.

MS BACON: Yes, they are, although I think names will be important for the next series of questions that I have.

THE CHAIRMAN: You must handle it as you think appropriate. It is your client's interests.

MS BACON: If there is any point that you think I ought to be referring to in terms of the details that I am not saying in open court then please let me know.

THE CHAIRMAN: I do take Mr Hoskins' point that you may ask your questions and Mr Harman may feel obliged to respond and he may not be thinking about the niceties of confidentiality when he does it.

MS BACON: That is why I just reminded him of it.

THE CHAIRMAN: But it is still not necessarily for him to do that. He is the witness and you are asking him questions.

MS BACON: Yes, but my questions are not designed to elicit an answer that might potentially transgress upon the confidentiality restrictions here.

So as a general proposition, do you agree that looking at whether products do make positive product contributions is informative or is likely to be informative to a decision as to whether to continue a product line?

A. In the short-term, yes.

Q. Can you keep that open and take up bundle N and look at tab 10. Again, this contains confidential information.

A. Which chart am I looking at?

Q. It is the diagrams attached to the letter at tab 10. Did you see those diagrams?

A. Only briefly.

Q. Can you look at the first of the attached diagrams which is headed "Figure 3". If you put that side by side with figure 7 which I have just taken you to on page 24 of CRA 2, do you see that in each case the ROS figure, and that is on the new letter, is slightly higher than the corresponding product contribution figure?

A. Is not figure 7 a gross profit and we are looking at return on sales in figure 3?

Q. Figure 7 is product contribution. Gross profit is over the page.

A. Because in my figure 7, if I look at the ledger below the graph, it says "Gross profit including amortisation".

Q. Well, the notes underneath say:

"Note 2. Product contribution takes account of the following costs ..."

And it then explains. And the gross profit figures over the page are different. So I think the ledger might be wrong but --

A. But then I would be -- even if that was the case I would be looking at profit contribution and comparing it to return on sales which are different profit measures.

Q. I am just saying: do you see that the product contribution is slightly higher than the return on sales?

A. Yes, that would be ...

Q. And do you agree that that follows mathematically?

A. Yes.

Q. As in it is a necessary function of the way you do the calculations that the product contribution will in all cases be a bit more than the return on sale, and it will differ by a constant across the different products?

A. Yes.

Q. If you turn back a few pages to page 18 of the CRA report, you will see there their calculations of the ROS of Flynn's products and this time with a volume-based allocation?

A. Yes.

Q. Again please do not read out the names of the products, but do you see that on this cost allocation, which is yours, several products have a negative ROS and, in some cases, very significantly negative?

A. Yes, I see that.

Q. Do you agree that if a company were to look at this set of figures, so figure 3 in the CRA report, it might conclude that those product lines were unprofitable whereas what we actually know is that they make a positive product contribution?

A. They make a positive one. It does not answer the question if it is sufficient.

Q. Right. But if a company looked at this particular chart and it saw that several products were in negative ROS figures, it could conclude that those were unprofitable?

A. I think what it would conclude is that it needs to look into why they are negative, and you would have to ask the question --

Q. I was going to get on to that.

A. -- whether something needed to be done about it.

Q. So do you agree that the reason why those product lines would be considered unprofitable, using this method of cost allocation, is that they have large sales but fairly small absolute margins?

A. Yes, I would say that they are marginal products, and particularly they may not be doing well enough, is what I would take from these numbers.

Q. Right. But without ascribing a value judgment, is the problem that they have small absolute margins per unit pack but they have large sales? Large volumes of sales?
A. Yes.
Q. And that is why, on a volume-based cost allocation, their large volumes of sales, as in large numbers of packs out the door, gives rise to a cost allocation which puts them into negative ROS?
A. I think that is where we are differing in our opinion --
Q. I am not asking an opinion, I am just asking if you agree with the factual explanation. Because if you do not agree I can take you to the actual figures.
A. I understand the maths. What I am disagreeing with is the interpretation.
Q. I have not put forward any interpretation yet.
THE CHAIRMAN: I think he is disagreeing with the interpretation that you are going to put forward.
MS BACON: Well, he is a very talented mind-reader.
If you agree with the mathematical explanation for why these companies are in negative ROS, so they are products that have small absolute margins per pack but lots of packs out the door, so that means they are cheap but very popular products in terms of sales.
A. Yes.
Q. And now I am going to put the interpretation: one would

ordinarily think it would be a good thing for a pharmaceutical company to be selling cheap and popular products, but if Mr Walters were to look at the ROS for those products on your cost allocation method he might conclude that, as you said, something was wrong, so he might conclude that he should either discontinue those or put up their prices significantly.

A. So -- and this is where we are going to disagree with the interpretation -- a finance director is not going to look, while making commercial decisions of product profitability, on one particular measure. Let me give you an example of it from my own organisation. I sit in a division that has equal numbers of people in them, and it is a fact that one of the teams has much higher revenue than the other, and both teams come together and we are (inaudible) on a common profitability measure. Let us call it 15 per cent.

We do not allocate common costs to those two divisions on the basis of revenues, because if we did do that, we would be able to equalise the margins between the two businesses, and that would give false weight to one division doing as well as the other when it is not. We allocate our common costs actually equally to the two and then we observe that actually one division is less profitable than the other. It follows obviously because it has lower revenues.

What do we take from that? We do not sit there and say "We are closing you down, business", though some within my practice would like to do that, but that is not what happens. The solution is to say "You have to sell more revenue. You are under-performing on the revenue line". If we had done it on revenue we would have said everything is good. That is poor management information.

And that is exactly what we see here. There is nothing wrong with observing negative profitability based on volumes, and on a commercial basis I would probably allocate things on a number of bases and try and understand what is happening.

So what would I conclude on these two charts? I would conclude that under a volume basis it seems that some products are not performing well enough, they may be marginal products but there may be an underlying cause that says they need to be more profitable, they need to be able to stand on their own two feet.

The problem with a revenue basis is that it "shelters" -- this is the terminology Mr Williams uses -- it "shelters" products. It takes from the very successful, the Phenytoin, and I say that there may be a circularity issue when it comes to Phenytoin.

But there is like a reverse circularity issue as well in that the products that have low product contributions are not taking their fair share of revenues.

It is all okay if all the prices across all products have sensible prices, but if you have a portfolio where some prices are too low and some prices are too high then you do get this sheltering effect and it would give you false weight on your product profitability.

MR LOMAS: If you were, to take your hypothetical finance director, trying to decide whether you maintain a product or not, is not an important part of that decision whether it has a positive gross margin as making a contribution to fixed costs rather than whether it is profitable when you allocate the fixed costs?

A. Correct. I would say there is a two-step thing. Obviously in the short-term you carry on with the product if it is making a positive gross margin. That does not help us when it comes to looking at excessiveness but that is the commercial decision and that is what the industry does. But then there is the second question that says what about the medium-term, are these products actually contributing sufficient amounts? And there the revenue effect shelters, it desensitises the underperforming and actually lowers the profitability of the good ones as well.

I would say that is kind of unfair, hence you would test it on a number of bases. In a commercial context you would do that, in a commercial context.

MS BACON: If I might pick up on that. If you would test it on a number of bases in a commercial context why would you not do so in this context?

A. Because in this context there are two -- I guess there are two issues in a competition assessment. One is am I allocating too much common cost to a product that might be excessive? So there is this internal circularity. That is if you were looking at the excessive question. If you are looking at the predation question, that type of allocation would then be allocating too limited costs to that product so its average variable costs would be much lower.

So from a competition perspective, the revenue is potentially distorting what your view on average total or average variable costs are.

Q. I am going to ask about revenues, but the basic point is if you, on a ROS analysis, end up with results that are wildly divergent from the results that you would get on a gross profits or product contribution analysis, does that not tell you that there might be something fundamentally wrong with allocating common costs in that way?

A. Sorry, I got lost.
Q. If you do a ROS analysis, which you have done, and on CRA's figures that shows you that some products are extremely unprofitable, and we know that that is not the case if you look at product contributions and gross profits, does that not indicate that the volume-based allocation is not the right way to do it, or is not the only way that you should be doing the allocation?
A. I think it is perfectly fair to say that it is not the only way. I do not disagree with that. I disagree with the fact that you would say that volume is an inappropriate method because I think that the alternative revenue is biasing the allocation in an inappropriate direction.
If the question is then what approach would I fall back on if I was not to use the volume approach, then I think the adjusted equi-proportional mark-up approach would be a good approach to use because that controls for issues of pack sizes, but it also standardises the cost of goods sold so that the cost allocation is not biased by a particular drug that has a high unit cost.
MS BACON: I was going to come on to that.
Sir, that might be a convenient moment to break.
Just to let you know where I have got to, I have 78 pages of notes and I am at page 45. On my

calculation I am doing about 15 pages every quarter of the day.
THE CHAIRMAN: It is rather like in a limited overs cricket match, you speed up towards the end, do you not?
MS BACON: Well, I am not sure if I am speeding up. I would estimate on that basis that I would be somewhere around the late 50s or 60 by the end of the day, maybe not quite as far, depending on how chatty everyone is in the second half of this afternoon.
THE CHAIRMAN: I hope you do not mean us.
MS BACON: I was using "everyone" in a very general sense there. I am conscious that Mr Brealey thinks he needs a couple of hours.
THE CHAIRMAN: I think we will carry on as we are and finish at 4.30 pm today and then we will take stock.
I take it, Mr Harman, there is no concept of excess profitability in your own organisation?
A. None whatsoever. Maybe predation.
THE CHAIRMAN: Thank you.
(3.19 pm)
(A short break)
(3.30 pm)
MS BACON: I come to the revenue basis of costs allocation. Am I right in understanding from what you have just said that your reason for rejecting that in this case as not

being informative is the circularity point?
A. There are two points. Circularity is the first. The second component is prices are also made up of unit costs, and Phenytoin has a high unit cost, and my concern with that is there is no economic basis to allocate more common costs to products just because they have a higher unit cost.
Q. So in that case it is a kind of circularity. You say it is circular because the Pfizer supply price might have been too high?
A. I think again there are two points. One is the first point as you just say, but that is not the only point, irrespective of whether it is excessive or not. I am not saying that because it is excessive then the unit cost is excessive and that biases it. The second point is merely that the unit cost is much higher than the other drugs.
So if I just did a quick example, not using any drugs and numbers so that I am not in confidentiality, if one drug had a unit cost of 5 and another had a unit cost of 7, my question from an economic perspective is why would I allocate more cost to the product that has a unit cost of 7 versus one that is 5? It does not make any sense.
Q. Is this a general point or one just about Flynn's

portfolio?

A. It is a general point and it applies to Flynn's portfolio.

Q. So your general point is that in any portfolio of product, whether it is drugs or cup cakes or whatever, if you have some products that have high unit costs, you think it is inappropriate to allocate costs based on revenue?

A. I think that caution has to come into it. Again, let me give some context very quickly. The use of EPMU, which is a unit base, which -- I know it is not the revenue but it is the same issue as revenue in a regulatory context, was that when you were looking at different products they may have different activities. You might have manufacturing, sales, debt recovery, and the accumulation of those different activities, you may have had ten activities of different costs, the philosophy is that if you had a product that has more activities then it is consuming your common costs more.

It was not really addressing the fact, well what happens if one of those activities on an activity basis had much higher costs, because what we were dealing with in a regulatory context was differences between the prices that electricity users use from pre-payment to standard, and the difference in cost there was that pre-payment had a pre-payment meter so it had an extra activity, and that extra activity consumed more common costs.

So I do have a problem that if unit costs are just higher and it has nothing to do with the number of activities that you are doing, then I think that could be distortive in the way in which you allocate costs.

Q. Does that not apply to pretty much any business which has multiple product lines, that in some cases the unit costs will be higher than others? So are you really rejecting a revenue approach in almost all cases on that basis?

A. I have never seen a revenue approach being used in normal commercial practice to allocate costs to products.

Q. We are talking about this particular sector where --

A. But we know --

Q. -- you have seen revenue, according to Mr Williams. Anyway, you have seen his evidence.

In your first report at paragraph 3.29 you refer to the circularity point and say that it is recognised in the Oxera report which you say was cited by Flynn. Maybe we should just turn that up. Could you be given bundle H1, please, and we will look at the Oxera report.

The Oxera report is at bundle H1/10. In

paragraph 3.29 you cite 6.18 of the Oxera paper. 6.18 is the passage that you have cited at 3.29.

A. Yes.

Q. And that is where they refer to the potential problem. What they say at 6.19 is:

"The primary solution is to use a cost allocation method that reflects cost causality."

But then they go on to say at 6.20, a paragraph which you do not cite in your report:

"Where allocation on the basis of cost causality is not possible, other types of cost driver including value-based ones must be used."

That was the passage that Flynn cited.

A. Yes, but --

Q. So, sorry, I am just getting to the question. So your first report in the passages that we have already looked at had already concluded that in this case allocation based on costs causality -- you qualify that by saying in the short-term is not possible. And what you actually said in paragraph 3.10 was that:

"There is no direct link between common costs and levels of activity, ie cost causation."

If we assume that at least in the short-term allocation on the basis of cost causality is not possible, so we are in the scenario that is painted in

paragraph 6.20 of the Oxera report. Are they not making the point there that, in that scenario, if one cannot look to cost causality, other types of cost driver including value-based ones must be used?
A. No, I do not think so. I think 6.18 --
Q. But I am not asking you about 6.18. I am asking you about 6.20.
A. There is a flow between the paragraphs. I cannot answer 6.20 without first addressing 6.18.
Q. I have asked you what 6.20 says.
A. 6.20 is talking about where cost causality cannot be applied then obviously you have to allocate them using some basis of allocation, including value-based ones. However, it has cautioned you at 6.18 that in doing so there may be a circularity.
Q. Yes, but --
A. That is my basic point, that sometimes revenue is fine, if it is not excessive then you might be able to use it, but there is a concern.
Q. Yes. So what they start off with saying, if you want to look at the flow, is that:

"Value-based cost drivers should be used with caution as a circularity problem may arise."

And then they say the cost causality principle should be used, and then they say it cannot be applied to all common costs. So:

"Where it is not possible, other types of cost driver, including value-based ones, must be used."

Is this not really saying we appreciate that there may be a problem here, but if you cannot use cost causality, it may be necessary to use value based drivers, but there is no single correct method and so what you should is to cross-check?

A. Yes.

Q. So that is not rejecting a revenue approach as being uninformative or unreasonable, it is just saying in that case, if you have to use it because you cannot allocate on the basis of cost causality, just treat it with an appropriate degree of caution and use cross-checks to test your result?

A. Yes, but I think the problem is that value-based drivers include a number of different types of value-based drivers, revenue is one of those, and it has just told you that if you are using revenues then you should be cautious of using revenues but other value ones may be okay.

It then goes on to say that you can use incremental and stand-alone which are the cross-checks that I have performed.

Q. Actually it said value-based cost drivers should be used with caution, it did not only say revenues. It said then:

"For example, if revenues ..."

So it was making a general point. I have taken you to that.

If you go back to your joint statement, you and Mr Williams then discuss the ways that one could cross-check for the potential circularity point in this case. If you look at page 11 of your joint statement, you are saying there that Mr Williams' sensitised approaches address the circularity problem but there are additional problems with both approaches.

I am not going to ask you about Mr Williams' sensitised approaches because that was put to Mr Williams in his cross-examination. I just want to look at your response here, and you are saying the sensitised approaches do address the circularity problem. But then your point, as I understand it, is that each of those suffers from its own problems?

A. Yes.

Q. Your first objection, and if we start with the first sensitivity analysis, which reduces Flynn's notional revenue to cost plus 6 per cent. My understanding is that you object that that calculates a new allocation of common costs based on the CMA's allocation of common costs and you say that that is in some way circular, is that your --

A. I did not say that it is an unusual two-step process that I have never seen, and the ultimate allocation of common costs is based on how the CMA first of all allocated common costs. In my mind that cannot be rational.

Q. Do you agree that all Mr Williams is doing here is saying on his first sensitivity: you, CMA, think that a revenue cost allocation might be biased in favour of Flynn, because the Phenytoin revenues might be too high. So that is the Flynn bit of the revenues.

So let us, for the sake of argument, just base the cost allocation on a Phenytoin price that the CMA agrees would not have been excessive, is not that what he is doing?

A. No, because if you were going to do that you would use the cost stack that the CMA had actually used. What you are doing is you are taking the CMA's cost stack and adding a bit more common cost to it.

Q. So this is just to pare down the notional revenues to a figure that would not be excessive so as to remove the suspicion that the costs allocation might be tainted by Flynn's excess profitability?

A. I am saying that this two-step allocation of common costs does not make any sense. In the joint meeting I said I have no problems with your second approach, that is a more rational approach. I still have a problem with it. But your first approach has this strange two-step cost allocation thing going on. I do not think it tells me anything additional to what your second one tells us.

Q. And what is your main objection to the second sensitivity then?

A. Actually there are two. The one that I quote here and one that I have just mentioned a couple of minutes ago. The point is that the second approach is effectively an EPMU approach but just for Phenytoin. Phenytoin is at cost without any profit in, and all the other products are based on their actual revenues. So you have revenue and you have cost.

Q. Can I just break that down. So your first point is that it is using a notional revenue for Phenytoin and not the actual revenue for other products?

A. No, it is using the actual revenues for other products and using a cost figure for Phenytoin.

Q. Sorry. Notional figure for Phenytoin and actual figure for other products?

A. Yes.

Q. Just pausing there, because I want to go through each in turn. So that is a sort of a notional versus actual point. Does that not miss the point that it is his intention to distort the analysis but in a way that is unfavourable to Flynn? Because he says, well, take the actual revenue for everything else, so they get a cost allocation appropriate to their actual revenue, but for Flynn we are going to reduce that to a sensitivity which you agree does not include the circularity problem. And that would mean, would it not, that on that basis Flynn had an unfavourable cost allocation by comparison with his base case?

A. The circularity is removed for Phenytoin, and the cost stack for Phenytoin is potentially sensible but for the fact that I think the cost is overstated.

But there is another issue, and it is the point that I was making about the low revenue products sheltering the excessiveness as well, ie their profitability is too low. And it just struck me that when we were looking at the Oxera report in 6.18 it mentions that particular issue. It says:

"Likewise, excessively low profits tend to be overlooked as the lower prices means that lower costs are allocated to that particular line of business."

The consequence of that is more cost is allocated towards Phenytoin because their prices are not

particularly high. So that is the first issue.
Q. So it comes down to -- well, I am not sure what it comes down to. I will have to think about that and look at the transcript because I am not sure I am understanding the point you are making.
Let us move on for the time being. As I understand it, your other point, and maybe this is the point that you have just been making, is that the revenue will include the supply price and that is the higher versus lower price point, is it?
A. I am not sure I follow that. But my second issue is that the Phenytoin cost stack is made up of its actual costs from Pfizer. That unit cost is extremely high in relation to the other products, and that alone allocates more costs. The issue is that when the Pfizer price changes, which it did significantly, then this approach would allocate significantly less to Phenytoin as a consequence. And I think why, as the unit price of Pfizer changes, should the allocation to Phenytoin also change? So there is a stability point there.
Q. That was the point I thought you were making. So if we are looking at Flynn's profitability -- and we are testing here Flynn's profitability, not Pfizer's profitability. If we are looking at Flynn's profitability, what is wrong with using Flynn's input

price, because Flynn actually did have to pay that input price, did it not?
A. I am not questioning the input price as being excessive and therefore you should not use it. The more nuanced point is that because it is very high, it is attracting much more common cost than it ought to. There is no reason, there is no economic reason to allocate more cost to a higher unit cost product. And there is a stability point that through time, as that changes, all the allocations of the business are going to radically change every time the unit cost changes of anything. And for me that does not fit with good allocating principles. Stability has to be one of them.
Q. Are you making this point about Pfizer's price. Are you saying that it distorts the analysis because it is excessive or just because it is high?
A. Because it is high.
Q. So your solution then is to -- this is your adjusted EPMU. Your solution is to reduce the notional revenue for Phenytoin to account for that and you reduce it to the CMA's cost plus cost plus, essentially, on both counts?
A. Yes, correct.
Q. So this is an excessiveness point, is it not?
A. No. What I am trying to say is -- and as ultimately

happened -- the price of Pfizer fell, and I am trying to replicate what that price would look like as the unit price changed. What I am trying to do with the adjusted EPMU is to standardise the distortion that is created by differences in unit cost. One could do that in a number of different ways. What I find that cross-check does is it gives me a very close answer to the volume-based approach and I think that is informative.

Q. Let us suppose we have a company with a supply line with lots of different products that have lots of different COGS, and let us suppose if you look at product contribution they all make about the same and you conclude on product contribution that none of those products was excessively profitable.

If the CMA were to do a ROS analysis across that company's portfolio, and it used a revenue-based allocation but reduced the notional revenues to account for the fact that some products or, let us say, one product had a particularly high price, you agree that that would then decrease the cost allocation for that product and then it would proportionately increase it for the other products?

A. In your example it would.

Q. Yes. That would then have the effect of pushing up the

ROS for the product in question and it would depress the ROS for the other products in the portfolio?
A. In your hypothetical question, yes. But the assertion that you are putting to me is that if things change, cost allocations change, and of course they do. That is a consequence --
Q. So I am putting to you if you take the entire portfolio and you decide that some of the input prices are too high, in order to correct for that you do essentially what you have done in your EPMU and you push down the notional revenue for one product, then mathematically that increases the ROS for that product and decreases it for everything else. So the result of that, which is essentially what one does on your adjusted EPMU, that makes the disputed product look like it has a higher ROS, and so that might result in the ROS looking excessive even if, if you looked at a product contribution analysis, all of the products in the portfolio had exactly the same product contribution.
A. I have to say I am finding it difficult to follow the maths. If we had an example I might be able to follow that easier.
Q. The point is a simple one. If you take a load of products which have the same product contribution but different input costs, so their total revenues are going

to be different. You say some of those input costs are quite high. So you say you cannot do a normal revenue-based calculation so you reduce the notional revenues for the products where you have a high input cost. Mathematically that means that the ROS on those products where you have reduced the revenues goes up?

A. That would happen. I start by saying that no allocation mechanism is perfect.

THE CHAIRMAN: That is assuming the effect of the allocation of common costs is significant.

A. Correct.

MS BACON: Yes. And I was going to come to that point. So you say -- there is another point on circularity that I need to cover off but before I get to that. On this example, let us suppose that you are looking at Flynn and Pfizer, is not the effect of your adjusted EPMU to bump up Flynn's ROS without telling you about whether Flynn is making a ROS that is excessively high, because all you are doing is adjusting to compensate for what you think is a particularly high supply price?

A. What I am doing is observing that the unit cost did change and that the allocation of cost before that change was extremely high under a revenue-based or an EPM approach to Phenytoin. And I am asking the economic question: why should the allocation of costs change when either price or unit cost changes when they have no relationship to cost causality? That is the simple point that I am making.

Q. You accept, do you not, that under the PPRS a revenue-based allocation is acceptable?

A. At the portfolio level.

Q. You have said in the joint statement that you think the potential for a circularity bias is limited because of the allowed return on sales under the PPRS?

A. Yes.

Q. Can I just look at what Mr Williams said about this in his cross-examination last week. Do we have a transcript bundle? Can I just give you Day 6 of the transcript. (Handed)

A. Thank you.

Q. Can you go to page 29.

A. Yes.

Q. Line 17, and can you read from there to page 30, line 21.

A. Row number?

Q. So start at page 29, line 17. That was the question. Then read over to page 30, line 21. (Pause) I think Mr Williams was just describing what he thought you were doing and I just wanted to ask you if you agreed with his description of what he thought you were doing.

A. And the question?
Q. Did you agree with that?
A. The point that I am making is that because there is a target and an MOT associated with that, then if you are allocating on revenue at a portfolio level then the issue of circularity is likely to be constrained because you are constrained by those two targets. Therefore, at a portfolio level this issue with revenue is not the same as in this instance when we are looking at a potentially excessive price placed on revenue. That is the only point I am making.
Q. So do you agree with his point that your comment is predicated on a company having a single line of business, and that was selling branded medicines to the NHS, or do you not agree with that?
A. I am not quite sure what he is saying here. But if he is saying that the bit of the business which is outside the PPRS may be excessive, then yes. But then the circularity is going the other way. You would allocate more costs outside the PPRS than inside and obviously the department would be less concerned with that because it is beneficial for the products within the PPRS.
Q. Are you saying it is okay if the circularity goes one way but not the other?
A. I am saying that the concern for the Department of

Health, who has said that you can use a revenue basis, from its perspective obviously it is okay if the excessiveness is going in a different direction to what it is trying regulate.

Q. Is that anywhere in the PPRS that you are aware of?

A. Is what in the PPRS?

Q. The point that it is all right for an excessive amount of costs to be allocated to the other line of business?

A. You have asked me to interpret what Mr Williams has said here and I am trying to interpret what he says.

Q. You have just said the Department would not be worried about circularity going one way rather than the other.

A. You asked me a question. I am speculating as to whether they would be concerned or not.

Q. Alright. Just because in footnote 30 of your first report you quote from the PPRS where it is said that:

"Overhead costs and shared assets utilised in both NHS medicines and other products must be reasonably apportioned."

A. Yes.

Q. That does not seem to me to indicate that the Department is only concerned about excess in one direction. It is referring to both NHS medicines and other products?

A. If that is the case then it must be that Mr Williams is wrong in his statement. I do not see how both can be

the same. Both cannot be internally consistent.
Q. He is saying that he understands your concern to be predicated on a company with a single line of business because if you had two lines of business, then you are going to have to allocate costs as between the different columns of the AFR?
A. Correct.
Q. And in that case there would be a concern if one or other of those were tainted by excessiveness. So his point is if that is the case, then there is potentially this circularity problem that could potentially arise in the PPRS. But you have accepted that under the PPRS, a revenue-based allocation is acceptable?
A. No. You have just told me the PPRS would not allow the circularity but you are suggesting that Mr Williams is suggesting that the circularity can be, and I am saying that both positions cannot be the same, they cannot be both right. Either there is no circularity, which supports my point, or, if there is a circularity, the circularity cannot be within the PPRS because it has a target. The only remaining place for that circularity to be, on your logic, is outside the PPRS which would be beneficial for the products within the PPRS.
Q. I think the basic point is that although the problem can obviously arise in relation to a PPRS allocation,

because one has to allocate between different products that are inside the PPRS and outside the PPRS, nevertheless the Department considers it acceptable for there to be a revenue-based allocation and that is the point?

A. I would repeat the point I have just said. I think Mr Williams and what the PPRS is saying seems to be at odds.

Q. Your point is that you think that ultimately the lack of a problem boils down to the fact that under the PPRS, the prices are constrained by the 6 per cent?

A. I think there are two points. One is that it is constrained at the 6 per cent and the second is that it is allocating to a portfolio and not to individual products.

Q. Where in the PPRS does one see any recognition of the fact that some products will have higher input prices than others which is the problem that you raise in this case? Because in the PPRS equally there are many portfolios where there may be much higher prices than others, and nevertheless a revenue-based allocation is permissible.

A. I think this is the portfolio and averaging effect. If you have lots of unit costs across a portfolio then issues between unit costs average out. But when you go to Flynn and you are looking at a small subset of products, and the one product of interest has a very high unit cost, then that is what causes a concern. Across a broad average between products outside the PPRS and products inside the PPRS, I think that average is likely to be averaged out and not be a concern, but it is definitely a concern once you get to a small company looking at 14 products.

Q. Is it not a general concern that products within the PPRS are likely to have much higher costs than products outside the PPRS? So when you are allocating -- when you, a company, are filling in your AFR and you are allocating between the PPRS column and the other column, are not you by definition likely to be allocating a far higher proportion of your common costs into the PPRS column because you are talking there about branded products which in general are likely to have higher prices than generic?

A. I think that is an assertion that you would need to look at the evidence. I think there are some branded products that are likely to have high costs and I think there are some branded products that are likely to have low costs, especially products that are off patent, do not have R&D, they are not having to pay for marketing anymore, versus generics that are entering into the

market and potentially have very high sales and marketing costs in trying to capture customers. So that is an empirical question and I cannot answer it without that data.
Q. But you did not do that empirical analysis?
A. I did not need to do that empirical analysis for my ...
Q. Can I ask you then to look at your alternative methodologies at paragraph 3.60. Again do not forget these figures are confidential.
So without referring to the actual figures, do you agree that those figures are predicated on, firstly, your cost pool and, secondly, the 6 per cent ROS?
A. Yes.
Q. So when you make your points about materiality in paragraph 3.62, of course that depends on what other parameters are used, does it not?
A. Yes.
Q. So can we just go through your different cross-checks in this paragraph. Starting with the revenue-based, and we have been through your reasons as to why you reject this, but just looking at the figure and picking up the point the chairman made about its significance, even predicated on your other assumptions being correct, do you agree that the scale of the difference between that and your base case, and without referring to the

numbers, indicates that the CMA's approach is quite
significantly unfavourable to Flynn?
A. It does allocate more cost to the volume-based approach,
though I would say that the difference is not
particularly large and that is in part because the level
of common costs as a function of other costs is
relatively small.
Q. But it is a significant difference.
If we then go to EPMU, Mr Williams has said he did
not have a problem with it but it leads to the same
result as a revenue-based allocation so I am not going
to ask you about that.
Then adjusted EPMU, and we have just gone through
that as well and I think we probably do not need to ask
any more questions about that. But do you agree, just
looking at the figure there, that this approach is quite
unfavourable to Flynn and even more so than your
volume-based methodology?
A. It is more unfavourable but it has a benefit because one
of the arguments that is raised about the volume
approach is that if pack sizes change, then the volume
approach does not adjust for that change but the
adjusted EPMU does. So that tells us a little bit more
about the volume-based approach. If it was true that
this was an issue for the volume-based approach as you

change packs, then I would expect that when we go on to a cost-based approach, that is adjusting for the unit costs, I would get a fundamentally different answer.

And because I do not, I think the examples that have been put forward are likely not to bias the volume-based approach.

Q. Incremental. As I understand it, that means allocating no costs at all to Phenytoin?

A. Yes, it reflects the business reality of what happened. Phenytoin was introduced and the common costs did not change.

Q. But given that we are required to allocate common costs, and the CMA is allocating common costs, is that not a methodology that allocates no common costs at all to Phenytoin, quite uninformative as to what method of cost allocation is the right one?

A. It is in the standard tool kit. And when I was taken to Oxera earlier, the final statement said that you would cross-check by reference to incremental and stand-alone, so I have just followed the standard tool kit as to the range of things that we would consider.

Q. Stand-alone costs. That is based on allocating 100 per cent of common costs to Phenytoin?

A. Yes.

Q. You say at paragraph 3.61 that:

"Flynn's prices are still materially higher than cost plus on this method of allocation."

A. Correct.

Q. So you agree that these calculations are based on your cost pool and the 6 per cent ROS. So when you say "materially higher", you are talking about materially higher using two other parameters that are disputed and are unfavourable to Flynn, are you not?

A. Yes. What I am doing in this analysis is checking the CMA's findings, that the CMA's findings are not predicated on its choice of cost allocation.

Q. And do you agree that the tribunal will need to look at whether the other parameters of the cost plus calculation are correct before it can make conclusions about the materiality of the excess?

A. Yes, I agree.

Q. Right. The second point on this, when you say "materially higher than cost plus", what is your reference point for what is material?

A. That is a good question. From my auditing and accounting background, materiality to me is always material if it is between 5 and 10 per cent of profits. That is the benchmark that I personally use for materiality. I think we must be clear here that I am not saying it is excessive, I am just saying the difference is material in my professional judgment.

Q. Yes, and I am only asking about the materiality . So have you tested what the standard deviation is from average portfolio ROS figures in this sector?

A. I have not, and I do not think that it would be relevant, because what you would be finding in the variability would be other factors, and those other factors would be investment, risk, common cost. So if you had a portfolio of ROSs, of comparables, then you could look at the variability and that might tell you something.

Q. Right. But you are using the PPRS as a comparable. Have you even tested the variability of the PPRS profits?

A. We know that it is bounded by the MOT at 9 per cent.

Q. And talking about individual products within a portfolio, are you saying that you have any idea about the variability of the profitability of individual products, whether within or without the PPRS?

A. No, I have not. I do not think that is relevant to the analysis I have done.

Q. So you are not saying material based on any standard deviation analysis, you are simply saying it is above a certain number which you have fixed at 5 to

10 per cent?
A. It is not a statistical calculation, no.
Q. I am going to come on to cost pool and I think that would finish the cost allocation issues. I hope to finish cost pool by the end of today and we might make some start on the gross profits.
So cost pool then. I think it is common ground that this is the second big issue with the cost allocation in this case?
A. It is.
Q. Is it correct to say that the dispute between you and Mr Williams is whether the amount of costs to be allocated under whichever method you choose should include the set of costs which relates to the sales and marketing expenses of products that are not Phenytoin?
A. Correct. It is about the allocation of costs which should be allocated to other products but are allocated to Phenytoin instead.
Q. Just to clear off another point, this is not a circularity point but it is a different point, is it?
A. I think it is a different point.
Q. Am I right to say that the dispute only concerns the situation where the benchmark ROS is drawn from the PPRS? So it is only if you are using 6 per cent or 9 per cent or something like that drawn from the PPRS

that Mr Williams disagrees with you?
A. At the beginning I went at pains to say that the 6 per cent being reasonable is not a PPRS 6 per cent, it is a 6 per cent based on --
Q. I was not asking you about that --
A. I am going to come on to --
Q. -- I was asking you about the scope of the dispute between you and Mr Williams, and Mr Williams understands, and I am just seeing if you also understand, Mr Williams' point is that he only puts forward his alternative higher cost pool in the situation where you are looking at the 6 per cent or the 9 per cent.
A. But, to finish, the scope of the dispute is that I do not recognise a PPRS scenario because I do not have a PPRS benchmark. It is an "in the round". So then when we come on to Mr Williams, then I agree in his world, when he is looking at the PPRS, he believes that the 6 per cent is from the PPRS and therefore must be constrained by the rules of the PPRS. But that is not a scenario that I run or consider.
Q. Let us assume against you that the tribunal finds that the 6 per cent is drawn from the PPRS, and I have put all those points to you and I am not going to go over that. If the tribunal finds the 6 per cent is drawn

from the PPRS, you have said at various times that the PPRS looks to portfolio of products. So do you agree that, in broad terms, what you do under the PPRS is to put all the costs for all of the branded products sold by the particular company to the NHS together?

A. Yes.

Q. Put all of the revenues from those together?

A. Yes.

Q. And see whether overall, and taking account of the various allowances and adjustments that are in Mr Williams' report, the aggregate profits are within the permitted levels under the scheme?

A. That is what he is saying but --

Q. I am just asking you if you agree with that --

A. But there is an aspect to that which I have to highlight. Because he has chosen to isolate a degree of common costs which are attributable but, under his argument of a portfolio approach, it applies to all costs. So at the level of abstraction, what Mr Williams is saying is we are going to allocate all costs -- should be saying we will allocate all costs --

Q. Could I finish my line of questions?

THE CHAIRMAN: Answer the question, when it comes.

MS BACON: So we have agreed as to what the PPRS is doing. Breaking down the costs that would go into that mix, and

I was coming to exactly the point you are making, do you agree that the costs that go into the mix under the PPRS would include all of the sales and marketing costs of all of the branded products as well as an appropriate allocation of the common costs of the company?

A. Yes, all costs ...

Q. Of the branded products.

A. Of the branded products. But then what you have just said is the key point; a reasonable, appropriate allocation of common costs.

Q. I was not asking about the common costs --

THE CHAIRMAN: I am beginning to see an element of circularity in this line of questioning.

MS BACON: Let us see where it goes. When you are doing a PPRS and you split between your branded products and your other products and you put into the branded pot all of the costs for that, including the sales and marketing, so all of the sales and marketing costs attributable to those branded products and you put in an allocation of common costs, and we are agreed on that. Let us assume that Flynn had prepared an AFR for its branded products, which we know it did not because it is below the threshold but let us assume it did, and let us assume that Phenytoin was a brand so that its AFR included Phenytoin.

Do you agree that what it would put in the cost boxes for that AFR on the branded column would include, firstly, an allocation of Flynn's common costs, which in Mr Williams' evidence would be by revenue?

A. Correct.

Q. Yes. And it would also include all of the sales and marketing costs attributable to all of the branded products in Flynn's portfolio?

A. On a direct basis, yes.

Q. Yes. So do you agree that, when the PPRS calculation is done, it does not look at the profitability of just one product but it looks at aggregate profitability?

A. Yes.

Q. So is it right to say that if one product has particularly high costs and another has low costs, in the context of the PPRS that all comes out in the wash because what the Department is looking at is aggregate profitability?

A. At a portfolio level, yes.

Q. So is the basic problem not that, if you pluck an individual product at random out of the portfolio such as in this example Phenytoin, if we had assumed that it had been in that portfolio of branded products, if you just look at its own direct costs and revenues plus an allocation of common costs, whether or not that

individual product looks like it is very profitable or very unprofitable will depend on whether it has high sales and marketing costs or none at all?
A. It would at a portfolio level. But, from an economic perspective, it can never be the case that you would allocate directly attributable costs for one product to another. So I understand the construct, but I am saying from an economic perspective in a competition assessment it is meaningless.
Q. I am assuming against you that we are comparing with something derived from the PPRS. So would it be fair to say that the effect of looking at profitability across a portfolio under the PPRS is that profits that might, when taken individually, be too profitable under the PPRS rules are shielded by the other products which have higher costs, so that nothing then across the whole range is too profitable?
A. You are right, and the key word there is "shielded"; you are shielding the excessive profits of one product against the lower profits of another.
Q. That is what the PPRS does. So returning to this case, when Mr Williams includes within his cost pool an apportionment of Flynn's overall sales and marketing costs is he not simply trying to correct for that shielding problem by taking account of the fact that

under the PPRS, if Phenytoin had been within the PPRS, the Department would have looked at the costs and revenues of the portfolio as a whole?

A. Yes. You are saying that the Department would look at the portfolio, but we are worried about the excessiveness of an individual product. We never say that the portfolio is the right metric, we say the 6 per cent is. It does not allocate to individual products and, because it does not allocate to individual products, we cannot actually use the PPRS scheme to understand what it would be at a product level, because it does not do it.

Q. But if you are trying to use a portfolio ROS, is not Mr Williams' correction a reasonable correction to make so that you are comparing like-with-like?

A. From an economics perspective, I cannot answer that question. We are trying to work out the excessiveness of a product, not the excessiveness of Flynn.

MS BACON: Sir, that concludes my questions on cost allocation. I am told that the clock is running ten minutes slow, so it is actually 4.20 pm. I am grateful to those behind me for pointing that out. If the tribunal has questions on cost allocation, then I will pause there.

THE CHAIRMAN: I think you can proceed.

MS BACON: I will proceed. We are now on to gross profits. Let us go to gross profits and start with some general questions. Could we look at paragraph 4.76 of your first report.
A. I have that.
THE CHAIRMAN: We are just discussing the time. Chatting.
MS BACON: A favourite English pursuit. Paragraph 4.76, that is your graphical presentation of the various different gross margin estimates and, as I understand it, Phenytoin is the black line?
A. Correct.
Q. Just to confirm, the third bar along, which is a blue bar, that is a range that is not drawn from a specific group of companies but, as I understand it, that represents the range drawn from various of Mr Davies' comments that are summarised in paragraph 4.79. Is that correct?
A. Yes, I think so.
Q. Just a definitional question, by gross profits do you mean revenues minus COGS?
A. Yes.
Q. Do you agree that gross profits have an advantage over looking at a ROS analysis in one respect, namely, that measurement does not require a cost allocation exercise?
A. Does not for what purpose?

Q. If you look at gross profits, you do not have to do a cost allocation exercise, do you?
A. Obviously the profit does not have an allocation of costs but it has a disadvantage that, if you are doing a cost plus, it tells you nothing about the other components of the cost stack that you have to include in your analysis.
Q. I am looking at the different measures of profitability that one can use, and the point about you doing a cost plus is that you have to find the plus and you derive that from the ROS and, in order to find the ROS, you have to do an allocation of common costs. But the point is that -- if I can just finish my question -- if you have a problem with the cost allocation and it is uncertain, you might want to look at gross profits too as a measurement, because that does not have a problem of cost allocation.
A. Yes, but caveated. If you are looking at gross profits, mathematically it implies that, if you were to allocate common costs, you would allocate them in proportion to gross profits. Basically you would take the gross profit line of each of your -- in absolute terms, and you would allocate your costs, your common costs on that basis. That would give you the same rankings proportionately as this type of analysis. So embedded

in the gross profit analysis is an "implicit" cost allocation, if you were to take it forward for the purposes of cost plus.

Q. But mathematically there is not a direct relationship there?

A. No, there is a direct relationship between them, but it is based on allocating on gross profits.

Q. Would you agree with this: if you are using a ROS analysis and if it turned out that the cost allocation under that is somewhat uncertain because you know for example that there is no cost causality for the common costs, or because there was some doubt as to whether a particular cost allocation was meaningful for the product or the industry, then would you agree that it would be at least informative to look at other approaches to assessing profitability?

A. Yes and no. The problem is with gross profits -- not the problem actually, gross profits, contribution and the ROS all point in the same direction. If you are going to use any of these measures in the way in which the appellants want to use them, they all point in the same direction. You could use gross profits, contribution and ROS. They would all give you the same answer because the answer would be: well, actually, when I compare profits to these comparators, Phenytoin does not look excessive. The problem is, if you look at gross profits and then contribution and direct, the problem is that they are all telling you the same thing and you are placing fake weight on it because you are just timesing the observation by three. The problem with gross margins is exactly the same for ROS though. It is not about the allocation of common costs, it is that you still have to adjust for investment, risk, volumes and unit costs. All of those factors that impact the ROS analysis also impact the gross margin and contribution analysis.

Q. I think you just said if you looked at all of those different measures, gross profits, product contributions and ROS, they would all point in the same direction and that Phenytoin does not look excessive on all of those measures.

A. But let me caveat so that is not taken out of context. What I am saying is they are pointing in the same direction, but I do not take them as good comparators because of those four dimensions.

Q. Yes, I was going to come on to that point. I was just clarifying what you were saying. Did Mr Lomas have a question?

MR LOMAS: No, it is fine.

MS BACON: You accept that, if you look at any of those,

they point in one direction only, which is that Phenytoin does not look excessive. So your answer then is to say: there is a problem because you do not think that they are good comparators and gross margins of other generic companies are.
A. That is not quite true, because when we have Flynn's products, we do adjust for unit cost differences and volumes and, when you take into account those two fundamental issues, Phenytoin looks like an outlier. So it is not just --
Q. I am going to come to your outlier analysis. If I could just pursue this line of questions, and you will have your say on the outlier analysis. In relation to Mr Williams' evidence, if we start there on comparators. Can you look at paragraph 4.77 of your first report.
A. Yes.
Q. You say at the end of that paragraph:
"For seven of the nine comparators Mr Williams does not comment on their comparability to Phenytoin."
Are the two that you do not mention Alliance and Martindale?
A. Correct.
Q. Can we look at what Mr Williams says about Alliance and Martindale, and I am conscious that the Chairman wants me to stop. Can we look at Williams 2. That is at

tab 12 of bundle D, paragraphs 37 and 38.

A. Yes.

Q. He comments on Alliance and Martindale in those paragraphs and he refers back to his first report. So we should also look at what he said in his first report in the previous tab, and that is at 73 to 82.

A. Sorry, can I have the reference again?

Q. Yes, the previous tab, so that is tab 11, paragraph 73, page 18 to paragraph 82 on page 19. Those are the paragraphs where he comments on Alliance and Martindale and explains why he thinks they are good comparators. Just to remind you that his first report was the evidence submitted in response to the statement of objections.

You will have read his evidence in both of those reports and you can see from those passages that Mr Williams explains why, in his expert opinion, Alliance and Martindale are good comparators for Flynn because of their particular business model, and I just want to check one point. You have not disputed Mr Williams' evidence on those points in your report, have you?

A. I think I say two things. I say, with respect to Alliance, I observed that it does contain patented products within it and Martindale I point out that it includes manufacturing. The second point that I say in my reports is that he does not make any assessment of what the relative risks and investments and levels of volumes and unit costs.

Q. That is a general point that you make, but he has given here expert evidence that, in his view and from his experience in the pharmaceutical industry, those are good generic company comparators to Flynn. Your expertise does not enable you to dispute that conclusion, does it?

A. Only the points that I have raised in objection to them; that they clearly have manufacturing. So I think because it includes manufacturing, I think that that definitely takes it straight out because, as we know, under the PPRS that accounts for 13 per cent of profit. So that would be profit not available to Flynn. So Martindale is definitely out, in my opinion. That leaves Alliance, and we know that it includes a patented drug and I do not know how that distorts the figures.

Q. So you are saying that any company that has some manufacturing cannot be a good comparator to Flynn?

A. No, because it would have different sets of activities that it would warrant a return on.

Q. What about all the companies in the PPRS?

A. But they are all included within Flynn's cost of sales.

It already has that profit baked into the cost of sales line. Where it would not be if Martindale has a manufacturing company in the UK. In effect, its cost of sales would be lower because it would not be receiving a transfer price that included manufacturing plus a profit, which we discussed earlier today.

Q. The PPRS does not really make any distinction according to whether a company has a manufacturing base or not, does it? The local ROS is the local ROS whatever it is?

A. Yes. My point is that, if you are looking at Flynn and you are looking at Phenytoin, its cost of goods sold includes a manufacturing cost and a profit component from the overseas company, Pfizer, and I am looking at Martindale, then its cost of goods sold is just the manufacturing cost, it does not sell to itself including a profit margin. So that is why you get a distorted view looking at a company in the UK that is integrated versus one that is across geographical bounds governed by a transfer price.

Q. But of course there will be some companies in the PPRS that maybe do not submit AFRs but which are manufacturing companies. How do you say the PPRS then is a good comparator for those?

A. We went through this this morning again. The answer to that is, on the PPRS, what is relevant for our analysis is the target 6 per cent rather than what the out-turn actually is. We know the out-turn will be bounded by the 9 per cent MOT. So I think we are consistent in our analysis.

MS BACON: That is probably a convenient point to stop. Do you want to take stock on where we are?

THE CHAIRMAN: Where are we?

MS BACON: I have about 20 more pages which, on today's rate of progress -- actually, I am at page 60, so that is exactly 15 pages every quarter of the day. That would suggest, with as fair a wind as we have had today, that I should be finished by lunchtime tomorrow. If there is a concern about the fairness of the wind we could --

THE CHAIRMAN: Before lunchtime, with a fair wind.

MS BACON: Yes.

THE CHAIRMAN: We are mixing our metaphors here.

MS BACON: We could start earlier or we could start at 10.30 am.

THE CHAIRMAN: One thing we cannot do is finish late tomorrow, because I have another commitment. I would hesitate to put that on the table, but I have.

MS BACON: It is right that you do, sir.

THE CHAIRMAN: So 4.30 pm to finish.

MS BACON: So 4.30 pm to finish.

THE CHAIRMAN: Mr Brealey?

MR BREALEY: I do not do cross-examination by pages, but I will be an hour and a half.

THE CHAIRMAN: You should try it. A new technique.

MR BREALEY: I think if we start at 10.30 am we will be fine.

THE CHAIRMAN: You do. Mr Hoskins, will there be lots of re-examination?

MR HOSKINS: No. I am not going to detain you, from what I have heard today.

THE CHAIRMAN: As long as you understand that we have to finish at 4.30 pm. So 10.30 am it is.

Mr Harman, you are in purdah overnight. I am sure you know you cannot talk to anybody about anything.

(4.33 pm)

(The hearing adjourned until 10.30 am on Tuesday, 14 November 2017)

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