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IN THE COMPETITION
APPEAL TRIBUNAL

Case Nos. 1205-1207/3/3/13

Victoria House,
Bloomsbury Place,
London WC1A 2EB

7th November 2013

Before:
THE HON. MR. JUSTICE ROTH
(The President)
STEPHEN HARRISON
PROFESSOR COLIN MAYER
(Sitting as a Tribunal in England and Wales)

BETWEEN:

BRITISH TELECOMMUNICATIONS PLC Appellant

- and -

OFFICE OF COMMUNICATIONS Respondent

AND BETWEEN:

(1) CABLE & WIRELESS WORLDWIDE PLC
(2) VIRGIN MEDIA LIMITED
(3) VERIZON UK LIMITED Appellants

- and -

OFFICE OF COMMUNICATIONS Respondent

AND BETWEEN:

(1) BRITISH SKY BROADCASTING LIMITED
(2) TALKTALK TELECOMMUNICATIONS GROUP PLC Appellants

- and -

OFFICE OF COMMUNICATIONS Respondent

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H E A R I N G D A Y E I G H T

A P P E A R A N C E S

Mr. Rhodri Thompson QC, Mr. Graham Read QC, Ms. Sarah Lee, Mr. Ben Lynch and Ms. Georgina Hirsch (instructed by BT Legal) appeared on behalf of the Appellant, British Telecommunications PLC.

Mr. Meredith Pickford and Mr. Julian Gregory (instructed by Herbert Smith Freehills LLP) appeared on behalf of the Appellants (1) British Sky Broadcasting Limited and (2) TalkTalk Telecommunications Group PLC.

Ms. Dinah Rose QC and Mr. Tristan Jones (instructed by Olswang LLP) appeared on behalf of the Appellants (1) Cable & Wireless Worldwide plc, (2) Virgin Media Limited and (3) Verizon UK Limited.

Mr. Pushpinder Saini QC, Ms. Kate Gallafent, Mr. Hanif Mussa and Ms. Emily Neill (instructed by the Legal Department, Office of Communications) appeared on behalf of the Respondent.

1 THE PRESIDENT: Yes, Mr. Saini.

2 Dr.. GEORGE HOUPIS, Recalled

3 Cross-examined by Mr. SAINI, Continued

4 Q Good morning, Dr. Houpis. Can I make a request from those of us that read the transcript.
5 You may have seen that the transcribers are finding it hard to follow what you are saying
6 because you speak very quickly, and there are various parts of the transcript where the
7 transcriber has not been able to record your answer. Can I just suggest that perhaps you
8 give your answers a bit more slowly?

9 A I will, yes, I will try.

10 Q Thank you very much. I just want to ask you questions about two areas this morning,
11 please, Dr. Houpis, and the first question is the difference between 2004 and 2008. As you
12 are aware, in 2004 a cost orientation condition was imposed, and in 2008 as far as low
13 bandwidth was concerned, that cost orientation condition was supplemented by a price
14 control. You are aware of that, are you not?

15 A I am.

16 Q Are you aware of the difference in market circumstances between 2004 and 2008, as
17 assessed by Ofcom - in other words, what was the difference that led to the different
18 approach in 2008?

19 A My understanding is that in 2008 the market was more mature than in 2004, and therefore in
20 terms of being able to impose a price control, it was necessary to forecast forward the costs,
21 because unless it had a reasonable amount of certainty or maturity in the market to be able
22 to do that, and I think that was the situation in 2008. As a reminder, when you actually set
23 those price controls you have to set it for a number of years, so you have to be able to
24 forecast not just what is going to happen next year, or in two years', but typically you would
25 need to forecast three years out or four years out, and, the level of uncertainty, the further
26 away you go from when you're actually setting the price control, the level of uncertainty
27 would increase. So my understanding was that in 2008 the market was more mature. It
28 reached a level where there was a better ability to forecast forward three or four years, and
29 therefore it would have been less challenging to put a price control and Ofcom opted to
30 adopt - to impose a price control. At the same time in 2008, when Ofcom analysed the
31 market it found that there has been significant excessive returns earned over a significant
32 period of time. That's my understanding.

33 Q Is not the reality, however, Dr. Houpis, that what had changed by 2008 is that the
34 competition which Ofcom expected would develop in 2004 had not developed, and

1 therefore that is why it decided to introduce the price control?

2 A In my view, if you go back to the situation in the market in 2004, my understanding of
3 Ofcom's analysis is that there were very significant barriers to entry in the low bandwidth
4 AISBO market, and I think the position in 2008 was actually not that dissimilar. They
5 found again that there were very significant barriers to entry, and therefore my own
6 assessment of that, is that the likelihood of entry, even in 2004, was probably quite low.
7 Therefore, the fact that in 2008 Ofcom found that it was able to earn significant returns is
8 not really a surprise.

9 THE PRESIDENT: Why did they not impose a price control in 2008 on high bandwidth?

10 A I am sorry, could you repeat that?

11 Q Why did Ofcom not impose a price control on high bandwidth in 2008, the same benefit of
12 being able, the market more mature?

13 A I think there are very different circumstances between those two market segments. If you
14 look at the high bandwidth market, what happens in that market is that the demand for those
15 services is concentrated very much in business districts, and therefore it is very concentrated
16 geographically in terms of where the demand is. The second element is, I think, the value
17 that customers for those services put on high bandwidth. It's much higher than the value
18 you put on low bandwidth because obviously there are more things you can do with the high
19 bandwidth services than you would be able to do with low bandwidth services. Therefore,
20 I think the implication is the expected revenues, if you are going to enter that segment of the
21 market, are significantly higher. As I mentioned, because I think on the geographically I
22 mention the demand is much more concentrated, the fixed costs are also much lower, and
23 therefore I think it's not surprising that there was some competition in the market, although I
24 seem to recall that that was the case even from 2004, there were already services being
25 offered by competitors in the high bandwidth market already from that date.

26 MR. SAINI: Can I suggest to you, Dr. Houpis, that, in fact, the position was that by 2008 the
27 anticipated competition which Ofcom hoped would develop in the market had not
28 eventuated. Is that not what happened?

29 A I think you are putting to me that Ofcom was anticipating a level of competition that didn't
30 materialise. My assessment is based on looking at the analysis in 2004, what was in the
31 document, and the economic factors driving the likelihood of entry. I do not think on that
32 basis that it was likely to expect a lot of competition in the low bandwidth market. I think
33 the objective factors in terms of the barriers to entry and the size of the market imply that
34 the likelihood of competition emerging was already in 2004 very low. In fact, I think in the

1 statement in 2004, because Ofcom has to do a forward looking assessment, when it actually
2 finds that BT has SMP, it actually says, "We don't see the circumstances changing over the
3 next two or three years in terms of competition in this market". I think that suggests to me
4 that the position in 2004 was, I think, if you are going to look at the evidence, that it would
5 be very unlikely there will be any entry in the low bandwidth market.

6 Q Perhaps I can refresh your memory. Would you like to look at bundle E, please,
7 Dr. Houpis, divider 13, which is the 2008 BCMR, which sets out Ofcom's rationale for
8 imposing a price control in 2008. Could you please go to p.235 of that document, the
9 bottom of the page, and could you please read to yourself 8.270 and over the page to 8.271
10 and let me know when you have finished reading them.

11 A (After a pause) Yes, I have read it.

12 Q Would you agree with me, having read that, Dr. Houpis, that Ofcom's expectations in 2004,
13 in particular the expectation about alternative infrastructure development, those expectations
14 had been defeated. There was not competition and therefore they decided that from now on
15 there was a need to introduce a strict price control. Is that not a fair summary of those
16 paragraphs?

17 A I think it's difficult from this to make an assessment about the 2004 view. What I read here
18 is that there were high returns and those high returns, there was no infrastructure investment
19 with those high returns. I think that is consistent with the answer I gave earlier.

20 Q If we look at 8.271, and I want you to focus, please, on the third line, it says there, if I may
21 read it with you:

22 "Since the 2003/04 Review, when these services were excluded from charge
23 controls due to the emerging nature of the market, we have found in Section 7 that
24 even with BT earning high returns on these services, very limited alternative
25 infrastructure has been deployed in this market."

26 As an economist, what is your understanding of what Ofcom is saying there?

27 A To me it looks like a factual statement which confirms what I said earlier about high barriers
28 to entry. As I said in my report, one of the important things to remember is that it is BT that
29 is setting prices in those markets, not Ofcom. In that context, what you would expect BT to
30 do is to consider when it is pricing those services what those prices could potentially mean
31 in terms of entry. I think it is Ofcom's suggestion, and there is disagreement between me
32 and Ofcom on that, or me and Mr. Myers on that, that the pre-entry prices could have an
33 impact on that. Under that assumption, and I'm not endorsing that assumption, then BT, I
34 think would try and set prices to maximise its profits, and it would have to take a view as to

1 whether it's more likely to have higher profits or lower profits if there was entry in those
2 markets. My view is that it would likely take the view that it would set those prices at a
3 level where it would not encourage entry.

4 THE PRESIDENT: Would you?

5 A Would not encourage entry in terms of that market. Therefore, even if one accepted the
6 theory that pre-entry prices affect the decisions for potential entrants in terms of what their
7 entry in the market, I think the fact that BT set the prices means that unless BT consider that
8 entry would increase its profits in the longer term, I would imagine that that implies that BT
9 would set the price at a level which would aim to deter entry in those markets. As a result
10 of that, BT would earn high returns because there are significant sunk costs for a new
11 entrant to come in the market. They have to go and dig the roads and set up an extensive
12 network, which BT has already done. So a new entrant has to put significant sunk costs,
13 and I think BT has a pretty good idea of what these sunk costs are. It knows what it costs to
14 actually dig the streets around the UK, and therefore one would expect it would set the
15 prices at a level where it would have as much return as it can, but it wouldn't set it that high
16 such that an entrant would be attracted to the market. So, in my sense, that assessment is
17 consistent with that view - i.e. BT earning high returns and no entry happening.

18 PROFESSOR MAYER: Could I just clarify on that point, is it your view that BT would set
19 prices below the entry level or that they would be able to discourage entry by cutting their
20 prices post-entry?

21 A My view is that it depends on the assumption you're making about the way in which a new
22 entrant would think about the market. My position is that I think a rational new entrant, I
23 would expect would take a decision about entry, where it could imply significant
24 investments, on the basis of the view about the likelihood of what would happen to the
25 market after entry, not pre-entry. So therefore it would have to come to a view as to the size
26 of the market and the revenues and the cost post-entry, and what BT might do with its prices
27 post-entry. That is my view. However, under Ofcom's assumption.

28 THE PRESIDENT: Just going back to Professor Mayer's question, you explained how the new
29 entrant would think. You were asked, on that basis, how would BT set its prices?

30 A How would BT set its prices? I think there are two possibilities. On the one hand is that BT
31 could also assume that for some parts of the market, the level at which it would set its prices
32 could potentially affect an entry decision. So, as I have said, it is possible that a new entrant
33 for some parts of the market would think that there is a link between the pre-entry and the
34 post-entry prices. I think, in general, it is better for BT set the prices as high as possible in

1 order to maximise its profits, and to the extent that BT thought that those prices could
2 provide an entry signal then it would not set them at such high level to incentivise entry.

3 PROFESSOR MAYER: But it is possible that BT could follow a strategy of setting prices with
4 the expectation that if entry occurred it could cut prices and thereby entrants from coming in
5 in the first place - is that not correct?

6 A I think that is possible.

7 Q In which case does it not follow then that you might still observe earnings in excess of
8 DSAC even if BT was concerned about entry?

9 A Right, I think if I just try and answer - I think the answer is "yes", but just to explain.
10 DSAC *per se* is derived in a certain way and provides a particular benchmark in terms of
11 cost, but it doesn't necessarily reflect the cost that an entrant would have to incur if they
12 were to replicate fully the whole network with BT. So in that sense it is correct that BT
13 could potentially price above DSAC to maximise its profit. Then, as you say, if then some
14 entry did occur it reduces prices down.

15 MR. SAINI: May I go back to the Chairman's question earlier in relation to high bandwidth,
16 please, Dr. Houpis, and if you have that document before you, if you could go back a few
17 pages to p.8 and para.1.29, which is where Ofcom consider the issue of high bandwidth and
18 if you would like to just refresh your memory and read paras. 1.29 and 1.30, please?

19 A (After a pause): Yes.

20 Q Would you agree with me that, as far as high bandwidth was concerned, there was exactly
21 the same cost orientation obligation as regards high and low bandwidth, yet as regards high
22 bandwidth there appears to have been significant entry into the market. Is that not what
23 happened here?

24 A As I explained, factually the statement is that there was competition in this market. As I
25 mentioned earlier, I think there was competition even from 2004, it's not like there was no
26 competition in 2004 and it appeared over the period. My understanding is that there was
27 already competition in 2004 in the high bandwidth segment.

28 THE PRESIDENT: When you say in 2004 - sorry to interrupt you - there was a finding that BT
29 had SMP in that market as well, so although there was competition there was not a
30 monopoly, there cannot have been, on Ofcom's finding, very much competition. Is that not
31 right?

32 A That's correct, but that segment of the market is very small. It's very small in 2007/08, it's
33 about 2 or 3 per cent overall. In 2004 it had been even smaller, it's a very small share of the
34 market, and I think there is also a materiality threshold. So it is possible that one particular

1 segment of the market is potentially - could be - more competitive than other segments, but
2 it would not necessarily be worth identifying it separately, as a separate relevant market.

3 But your statement is correct.

4 So if I go back to the question of Mr. Saini, as I was saying earlier the revenues from that
5 market are likely to be much bigger, and also the cost to entering that market, compared to
6 the revenues, are likely to be smaller. I think I said in my statement what new entrants
7 would look at, in terms of deciding about an entry decision, is what would happen in the
8 market after they enter, and that would involve assessing revenues and costs in the market
9 after their entry. I think that's what happened in this market.

10 MR. SAINI: I want to turn to a related but different subject and you could perhaps put away that
11 bundle now and could you please be provided with the expert bundle, which is bundle B,
12 and could I ask you, please, to turn to divider 13, which is Mr. Myers' statement and p.40 of
13 that statement. Before I ask you to look at any particular paragraphs, I want to just ask you
14 at the level of theory first of all before we look at the facts, and I ask you this question
15 because it is not clear to me what your position is based on the joint expert reports. It is
16 p.40 of divider D13. On the level of theory would you agree with me that a DSAC test
17 compared to an aggregate FAC test might reflect a different balancing of economic
18 efficiencies. In other words, one might take the view that one is going to adopt a DSAC test
19 for assessing cost orientation because a view might be that that promotes dynamic
20 efficiency, although it may harm allocative efficiency. Equally, one might take the view,
21 which I believe you do, that you prefer your FAC aggregate test because it promotes
22 allocative efficiency and also has dynamic efficiency benefits. There is an assessment to be
23 made, is there not, as to which test promotes which type of efficiency? Just as a matter of
24 theory would you agree with me?

25 A If I may ask - you are asking me as a matter of theory and then you are giving me a specific
26 example, which one for my answer?

27 Q I am using DSAC and aggregate FAC, just as a matter of theory one can take different
28 views when selecting which test to apply. One could take different views as to whether or
29 not one test or the other will promote allocative efficiency or dynamic efficiency or
30 productive efficiency?

31 A Let me try and see if I can answer the question as I understand it. My understanding of Mr.
32 Myers' critique is that he's ----

33 Q Can I just stop you? I do not want you to answer about Mr. Myers' critique but as a matter
34 of theory, as an economist, different tests of cost orientation will have different properties in

1 terms of how they promote allocative dynamic and productive efficiency, just as a matter of
2 theory is that not correct?

3 A I can't answer in the abstract whether some test would have different or not different
4 properties. I can accept that there are trade-offs between allocative and dynamic efficiency
5 in a specific context, in theory, there can be those trade-offs.

6 In terms of then answering the specifics, I need the specific context in which the question is
7 asked and then I will answer it.

8 Q A specific example, and I am not talking about Mr. Myers' critique, let us say DSAC.
9 DSAC, it is accepted, may lead to the over recovery of common costs, do you accept that?

10 A I accept that.

11 Q You also accept, I believe, that a regulator might make a decision that it will accept that
12 result because it might promote dynamic efficiency?

13 A Let me see if I can try and answer the question. My views, as I said in my report in the
14 earlier conversation, in the specific context, is that by allowing prices to be higher up above,
15 let us say, fully allocated cost then the implication is that given BT is setting those prices,
16 my view is that there should not be an expectation that this would lead to increased
17 likelihood of entry, given the significant sunk cost.

18 Now, if the objective was to incentivise entry, given this approach, then I think to my mind
19 the right approach would not be to put a ceiling on prices, it would be to put a floor on
20 prices. If you are really interested in dynamic efficiency, and I think that goes back to
21 Professor Mayer's question, the risk could be, if BT was really concerned about entry, that it
22 would price very low to deter an entrant from coming in the market, that's why the LRIC
23 floors are there and BT can price at the LRIC or DLRIC.

24 So if Ofcom was trying in this context to incentivise entry then it would seem to me that
25 what the potential consideration should be, given the way that I describe my understanding
26 of how the market works would be to set a floor. So what you are then doing is to say: "I
27 accept that there may be some inefficiencies by putting this floor. I accept that prices short
28 term would be higher than they could be, because BT could reduce those prices." But you
29 are basically saying to BT: "You cannot use a price below that level in the short term". That
30 may well be allocatively inefficient, because BT could recover its cost by its prices being at
31 the lower level and then there is this short term inefficiency which, if entry occurs,
32 obviously you would expect to deliver the benefits for longer.

33 So in that context I am not entirely sure that a ceiling, which is I think the implication of
34 your question, up to DSAC prices, when BT is setting those prices and it can act in the way

1 I describe, it is not quite clear to me how that would promote dynamic efficiency. So given
2 that in the specific context I am not sure I could see the ...

3 Q Well, that is on the particular facts of this case, I was asking as a matter of theory because
4 you are aware that Ofcom's position is, and Mr. Myers' position is that the decision to
5 choose DSAC as the cost measure and the decision not to impose a price control was
6 effectively to encourage competition. You are aware of that, are you not?

7 A I think we have covered that ground yesterday.

8 THE PRESIDENT: I think what Dr. Houpis is saying is that it is difficult to answer in theory for
9 any market because the circumstances of different markets are, by their nature, very
10 different. In this market he accepts that, in theory, you can have trade-offs between
11 allocative efficiency and dynamic efficiency and you might have to make a Judgment as to
12 which you favour. I think his point is that he does not think in his view that a DSAC ceiling
13 does promote dynamic efficiency. Am I right? Therefore this was not a valid trade-off in
14 this case. Is that a fair summary?

15 A In this specific case that is right, yes.

16 MR. SAINI: If I can ask you to look at a particular page of Mr. Myers' statement, para.94?

17 A Yes.

18 Q Do you disagree with the proposition put in 94 that when Ofcom decides how to regulate
19 markets that it has to undertake complex efficiency trade-offs?

20 A No, I don't disagree with that.

21 Q And I do not believe there is any dispute about the description in para. 95 of the different
22 types of efficiencies, all the experts are agreed that those are fair definitions?

23 A That's correct.

24 Q If I can try and summarise your evidence you believe that insofar as Ofcom undertook a
25 dynamic efficiency assessment in 2004 you believe that it came to the wrong conclusion in
26 2004. Is that a fair summary of your assessment?

27 A Sorry, the wrong conclusion in relation to what? If you can maybe rephrase, make the
28 question a bit more ----

29 Q Perhaps I will put it more directly. In 2004 Ofcom decided not to impose the price control.
30 You understand that?

31 A Yes.

32 Q And Ofcom's position is that it decided not to take that extreme step because it wanted to
33 encourage competition, you accept that?

34 A I accept that this is one - yes - that was one of the possible checklist.

1 Q Your conclusion is that in 2004 that Ofcom, in taking that approach was making an
2 economic error?

3 A No, I don't agree with that.

4 Q So what is your approach to what Ofcom decided in 2004?

5 A My view is that in 2004 Ofcom was facing three options. One option was not to regulate
6 the market at all, and it was clear, given the circumstances, that it could not regulate the
7 market and not intervene. Then once it decided to intervene it would have to decide
8 whether to deploy price control or a cost orientation obligation. I think in order to impose a
9 price control it would have to make, as I said earlier, a forecast of cost for a long period of
10 time. The further the period of time they are forecasting ahead the greater the likelihood of
11 getting that wrong.

12 Now, if you set prices such that BT cannot put prices above that level it is possible with a
13 price control that you might get the prices wrong and either set them too high or too low. If
14 Ofcom set them too low, with a three or four year price control I think there is a real risk of
15 deterring entry because Ofcom could get it wrong and set the price control at the level
16 which could be even below the cost of an efficient entrant, that is quite possible.

17 Therefore, I think in that context it does make a lot of sense, even if you want to promote
18 dynamic efficiency and efficient entry to adopt a cost orientation obligation and not a price
19 control, because the reverse would not necessarily be true. If the prices were too high for
20 the reason I said earlier that would not necessarily cause you a problem in terms of entry.
21 But if the prices were too low then there could be a risk that you would deter efficient entry.
22 So I think in those circumstances cost orientation is more appropriate than price control.

23 Q So is your understanding that in 2004 the reason that Ofcom did not impose a price control
24 was because Ofcom was uncertain about the prices it should fix. Is that your
25 understanding?

26 A I think the reason Ofcom imposed a price control, as we discussed yesterday, is summarised
27 in one paragraph, indeed in one sentence, and my understanding of that is that it contains
28 two elements. One is that the market was nascent, which is consistent with what I just said
29 now, that you cannot forecast costs. That's quite a common position. It's Ofcom's position
30 in the current consultation on cost orientation. The second part of that was about the
31 competitiveness of the market. As I said, in my mind those two things go together. You
32 would still want a cost orientation obligation if you were interested in the competitiveness
33 of the market. To impose a price control would entail a significant risk of deterring efficient
34 entry. So in my view those two things are consistent between them.

1 Q Thank you very much, Dr. Houpis.

2 THE PRESIDENT: Mr. Thompson next, I think.

3 Cross-examined by Mr. THOMPSON

4 Q Good morning, Dr. Houpis. I represent BT in this matter. Can we first of all look at your
5 statement number one core bundle D tab 8.

6 A Yes.

7 Q At the end of para.1.1 you say:

8 "I have also advised clients on competition cases and disputes, including
9 assessment of competition and market analyses of fixed and mobile markets, and
10 cases of alleged abuse of dominance and anti-competitive behaviour."

11 Then you exhibit your CV at Annex A. Looking at it, it is obviously a very impressive CV,
12 and you have specialised, as I understand it, in telecoms and post regulation. Those are two
13 of your specialisms, is that right?

14 A That is right.

15 Q Can you now look at 1.4, the second sentence:

16 "I have also been instructed to assume that a key objective of Ofcom when it was
17 imposing the cost orientation obligation in the present case was to achieve price
18 levels consistent with what could be expected to be observed in a competitive
19 market and avoid BT being able to set prices at excessive levels."

20 Do you see that?

21 A Yes.

22 Q Then if we turn to your third report, tab 10, para.3.7

23 "An important objective of Ofcom when imposing an ex ante price regulation
24 obligation (in the form of a price cap and/or cost orientation obligation) is to
25 prevent BT from setting excessively high prices which would allow it to earn
26 excess economic returns..."

27 Then at 5.2 you say something very similar:

28 "A key objective of the cost orientation obligation is to ensure that BT does not set
29 excessively high prices for services in the provision of which it has been found to
30 be dominant."

31 A Yes.

32 Q I would like to ask you some questions about excessive pricing, which I think is also called
33 unfair pricing in competition law terms, is that right?

34 A Yes.

1 Q First of all, it is not equivalent to a simple costs plus test, is it, the concept of excessive
2 pricing in competition law?

3 A I'm not sure – what do you mean by costs plus test?

4 Q You must have done many cases in relation to excessive pricing. It is not simply a question
5 of looking at the costs and adding on a bit, and then if you get to a certain figure that is
6 excessive or unfair. It is not a simple costs plus test?

7 A Right. Can I just go a step back, because I think the context – you are asking me questions
8 about excessive pricing in connection with competition law. That's not the point why we
9 are here. The case before us is not one of BT being accused of excessive pricing under
10 normal competition law. BT has been found to have SMP. My understanding of the
11 regulatory framework is when an operator such as BT is found to have significant market
12 power then one of the objectives, and an important objective, is to have a regulatory
13 framework which ensures that that company is not able to exercise that market power. One
14 of the important reasons to do that is because absent that ex ante obligation, the presumption
15 is that the regulated company would be able to set prices at too high a level. Hence,
16 excessive level. In my view, in the context of the current case the question before us is not
17 some general question as to whether BT charged excessive prices or not within a
18 competition law framework. The question before us is we have two tests – we have the
19 Ofcom proposal and then we have what has been called the Houpis 1 test – and the question
20 --

21 Q You are getting ahead. I am simply asking you a question about excessive pricing, and I
22 think you are agreeing with me that it depends on the nature of the market, for example, the
23 profitability of the upstream/downstream and it is not an all or nothing question; it is a
24 question that is relative to the market. You have made some points about the market here.
25 It is not an absolute question, is it?

26 THE PRESIDENT: I do not think that was your question, Mr. Thompson. What Dr. Houpis is
27 saying is that the concept of excessive pricing and competition law jurisprudence (which I
28 think he is familiar with although he is not a lawyer) is not the concept that applies here in
29 this case. Is that right?

30 A That is right.

31 MR. THOMPSON: That is a question of law, and I am at the moment asking him some
32 preliminary questions about the nature of excessive pricing as a concept of competition law
33 because in so far as the issue of law is concerned, I would submit that it is quite plain on the
34 legislation that it is the same concept.

1 THE PRESIDENT: So you are asking about the competition law concept of excessive pricing
2 and you said in competition law terms it is not just costs plus?
3 MR. THOMPSON: That is all I am asking. It depends on the nature of the market. That is right,
4 is it not Dr. Houpis?
5 A I think it is correct that when one looks at excessive pricing within a competition law
6 framework it would be a different framework, and consider different assessment than you
7 would in a regulatory framework. But to my mind the question here is whether in the
8 current framework, not in a competition law framework because BT doesn't operate in this
9 market under a competition law framework – can I finish?
10 Q I think it is a very important question I am asking you and I understand what you are saying
11 about the current market, but I am simply asking you as an expert in this field that excessive
12 pricing is not a simple matter of numbers, is it?
13 A In the abstract? Are you telling me this generally, under competition law is excessive
14 pricing a matter of numbers?
15 THE PRESIDENT: That is also a question of law, is it not, what excessive pricing means in
16 competition law?
17 MR. THOMPSON: But this is somebody who has practised in the field.
18 THE PRESIDENT: Yes, but you do not have to ask an economist as to what the legal meaning of
19 excess pricing is.
20 MR. THOMPSON: Very well, I will move on. Would you accept here that we are dealing with a
21 stripped down system of regulation, based on two forms of pricing reviews: excess pricing
22 and margin squeeze? You are presumably familiar with the regime in outline terms. There
23 are two issues here: excessive pricing and margin squeeze. Those are the two items relevant
24 to this regime? That is right, is it not?
25 A My understanding is that there are other elements as well, but two of those elements are the
26 ones you mentioned.
27 Q But under the statute, I am sure you are aware that it is excessive pricing or margin squeeze;
28 that is the basis for this regime. That is correct, is it not?
29 A Could you be more specific with statute? Which regime are you talking about?
30 Q Yes, certainly. We can look at it. I assumed you would know this. We can look at the
31 statute. It is at core bundle E tab 5 p.21 in big numbers at the bottom. You will see the
32 conditions for Ofcom about network access pricing. Do you see that, s.88?
33 A Yes.
34 Q Then 88.3 it says:

1 "For the purposes of this section there is a relevant risk of adverse affects arising
2 from price distortion if the dominant provider might—

3 (a) so fix and maintain some or all of his prices at an excessively high level, or

4 (b) so impose a price squeeze,"

5 That is another name for a margin squeeze. That is the basis for Ofcom's jurisdiction.

6 That is not just a theoretical point because that is what actually happened in the 2004 market
7 review. You find that at tab 12 in bundle E. If you turn to para.7.68 on p.169:

8 "Ofcom considers that imposition of a cost orientation condition satisfies section
9 88 of the Act. Without it, there is a relevant risk of adverse effects arising from
10 price distortion because BT, as it has SMP in this market, has the ability to price
11 above the competitive level, so as to have adverse consequences for end users of
12 public electronic communications services."

13 That is a classic statement of an excessive pricing concern, is it not?

14 A What you said, that is correct.

15 Q That was the basis for this provision being imposed, was it not? That is what it is saying.

16 A That is the legal framework, yes.

17 Q Can you turn to core bundle B, which is the Determination itself section 9.101. I think you
18 will recall that there was no mention of margin squeeze in the 2004 review that we have just
19 looked at. It appears that TalkTalk did make an allegation of margin squeeze in relation to
20 this matter, but the conclusion of Ofcom on that issue is at 9.101 to 102 and in particular
21 101:

22 "Our view in response to TTG and BT's representations regarding margin squeeze,
23 is that cost orientation is a separate piece of regulation designed to provide
24 bounded flexibility to BT in setting prices, and is not directly employed to prevent
25 margin squeeze and discrimination. We have separate tools specifically designed to
26 address such concerns, such as EOI, non-discrimination conditions and
27 Competition Act powers. Therefore, we do not consider it necessary or appropriate
28 to alter our approach to enforcing cost orientation obligations to address such
29 concerns."

30 So this was not a regime directed at margin squeezes, was it? In any event, you have been
31 discussing the remedy and whether it was a good remedy for dynamic efficiency. This
32 would have been a very poor remedy for margin squeeze, would it not, because it would not
33 have addressed the margin?

34 A Could you repeat your question?

1 Q You understand what a margin squeeze is? It is the difference between two prices, is it not?
2 A yes.
3 Q So a remedy for a margin squeeze would need to address the difference between two prices:
4 the retail price and the wholesale price. That is right, is it not?
5 A That's understood, yes.
6 Q This does not address that question, it is not a retail minus obligation or anything of that
7 kind?
8 A Yes.
9 Q So it would have been a hopeless remedy for margin squeeze?
10 A Quite.
11 Q So the issue here is limited to a remedy designed to pre-empt a perceived risk of excessive
12 or unfair pricing. That is right, is it not? That is what the 2004 review says and that is what
13 the Act says.
14 A I mean you are asking me questions on the legal framework. I think my understanding and
15 interpretation of this is that there is an overriding objective in terms of Ofcom's objective,
16 which is to ensure that the decisions are to the benefit of consumers, and therefore I think if
17 there is a practical remedy which results in prices being lower than they would otherwise be,
18 absent that remedy, then I think that I would expect, absent any other considerations
19 (because the authority will have to look at all the considerations I have looked at in my
20 report, and that Mr. Myers has looked at in his report), but that would be instrumental to
21 achieving those objectives.
22 Q Yes, but here we have Ofcom, who is a regulator, who is seeking to set a suitable standard
23 to approximate to a price that is not excessive or unfair. That is what is going on here, is it
24 not? They are acting on a risk of excessive prices and they are trying to set a condition that
25 pre-empts that risk. That is what is going on here?
26 A I do not think so. I think what is going on here is BT has an obligation to set prices for cost
27 orientated services so that they recover no more than the forward looking incremental cost
28 of offering the services, an appropriate mark-up for common cost, including a reasonable
29 level of cost of capital. That was what Condition HH3.1 says and that is what, in my mind,
30 in terms of the implementation of the remedy, that is the key text from which to start. I
31 appreciate that there is a whole legal regulated framework which then leads to Ofcom
32 imposing that condition, but in terms of cost orientation obligation I do not need to go and
33 analyse the whole regulatory framework. There is a condition. It is very clear what it says
34 in my mind, and therefore what I think we need to consider is the consistency of an

1 approach that Ofcom has taken, and the test that I have proposed, with that wording and
2 implications of that.

3 Q I do not want to get into issues of law but there is basically a hierarchy from the Act down
4 to the review and then to the condition, and we have looked at the basis on which this was
5 put in. That was 7.68 of the 2004 review. That is right, is it not?

6 A I think I have answered you. I am not sure. I think I have answered.

7 Q But if Ofcom was trying to avoid excessive or unfair prices or drive prices down to a
8 competitive level, would you accept that DSAC is a reasonable proxy for that exercise? It is
9 not the only possibility but it is a possibility that the regulator might choose?

10 A Let me just answer that in two stages. My first point is that I think the objective here is to
11 make sure that the prices that result from the two tests are consistent with the cost
12 orientation obligation, and I think that the implication is that one has to look at the two tests,
13 understand the implications of the different efficiency criteria ----

14 Q We are not on the two tests. We have just on Ofcom's test, the DSAC test. I am just putting
15 to you that is a way a regulator might try to cap prices so they were not excessive. That is
16 not an unreasonable proposition, is it?

17 A I will come to that, if I may.

18 Q Do you disagree with me or not? There is a limited amount of time and if you do not
19 disagree with me then we can move on.

20 A I think you will probably find, if you let me finish, I would disagree. But can I finish and
21 say it in my own words? So I think the implication is that Ofcom has to set a test which
22 results in setting prices which are consistent with the cost orientation obligation and, in my
23 view, then if the economic efficiency criteria are important you have to look at the
24 economic efficiency criteria to judge the Ofcom test and then judge the Houpis test and that
25 is, in my view, the key objective. In terms of whether setting prices at DSAC is consistent
26 with that objective, I think I have set out in my statement that I believe that if one looked at
27 what overall the prices would be, then prices at DSAC would be unlikely to be consistent
28 with this. ... To show this, it is useful to do a thought experiment. Let's assume all of BT's
29 prices are set at FAC, which would then imply that BT is earning no more than the cost of
30 capital, reasonable returns. If you then take a sub-set of those services and increase the
31 prices to DSAC, then those prices would probably not be consistent with what you would
32 observe ... in competitive markets because an entrant could come in and undercut those
33 prices. And in that sense, I also explain that pricing at DSAC I think would be less
34 consistent with what you would observe in competitive markets, and that is the position I set

1 out in my second report -- in my fourth report, I am sorry.

2 Q Let us stick with DSAC for a moment. Say it is a cost standard and it adds some substantial
3 additional headroom for fixed and common costs. That is true, is it not?

4 A Sorry, could you repeat your question?

5 Q DSAC starts with LRIC and then adds headroom based on fixed and common costs. That is
6 right, is it not?

7 A That is correct.

8 Q There are other ways you could do it but it is one way of doing that particular exercise.

9 A It is one way but it has a specific characteristic which is that if you set everything at DSAC
10 you recover more than your common costs.

11 Q I know you do not think it is the best way but it is one way, is it not?

12 A It is one possible way, yes. Yes.

13 Q Can I just press you a little further on the nature of an excessive or unfair pricing analysis?
14 Like any other case on abuse of dominance or use of market power, the basic building
15 blocks are market definition and proof of dominance. Is that correct? (After a pause): You
16 may find these questions too easy to say "yes" to, but the basic building blocks are market
17 definition and proof of dominance. That is correct, is it not?

18 A In a competition case where you are trying to establish whether someone has abused the
19 dominant position then, yes, you would have to define the relevant market and then come to
20 a view as to whether they were dominant or not and whether they abused the position of
21 dominance.

22 Q Yes, and that is also true of SMP regulation under the CRF in the 2003 Act, is it not?

23 A I am sorry, my understanding is that under the current regulatory framework Ofcom does
24 not have to establish that BT has abused its dominant position. That is a fundamental
25 difference.

26 Q No, I did not say that. I was talking about the first two stages, market definition and proof
27 of dominance. The SMP character is based on dominance under EU competition law. That
28 is correct, is it not?

29 A I think it is correct in terms of a strict comparison but I think it is a different test, in my
30 view, because I think the presumption is, and that is a presumption, but if a company is
31 found to be dominant in the telecommunications sector under the regulatory framework the
32 regulator has to, they have to, they do not have an option, they have to take certain measures
33 to make sure that that company does not abuse the position of dominance.

34 THE PRESIDENT: I think you are being asked a much simpler question, namely that as with a

1 competition law analysis, under the regulatory framework the regulatory has to start by
2 defining the market and establishing dominance, or SMP which is the same as dominance.

3 A In that sense the answer is yes.

4 MR. THOMPSON: There are very detailed provisions about it in CRF and in the 2003 Act and
5 there is extensive guidance from the Commission, is there not, on the whole question of
6 market definition and SMP?

7 A I understand I believe this to be the case, yes.

8 Q Yes. In principle a market may be a simple one for a single commodity or a service, for
9 example a specific medical treatment, or it may be a composite one for various things all
10 together in one market. That is true, is it not?

11 A As a matter of principle, yes.

12 Q It may help us to make this more concrete if we look at a particular example which your
13 own team has put out as an example in your skeleton argument, and that one finds in the
14 authorities at Authorities 2, Tab 36.

15 THE PRESIDENT: *Albion Water?*

16 MR. THOMPSON: Yes. The case is familiar to Mr. Pickford and myself having spent many
17 happy days together in this courtroom over a period of years. I do not know if you are
18 familiar with the facts of it. It is a reasonably well-known case about margin squeeze and
19 excessive pricing in the water industry.

20 A I am not familiar with the details. I am familiar with the case but I am not familiar with the
21 details.

22 Q There is no need to go into the details, but if you could just turn to para.33(a) on p.10 of the
23 transcript, and if you look at p.9 ----

24 A So shall I go 33?

25 Q If you turn to p.9 and para.33, and you will see there a summary of findings that were made
26 in previous judgments because this is a case about unfair pricing. This is what the judgment
27 was about. If you turn over to p.10 you will see that the finding was that:

28 "Dwr Cymru [or Welsh Water] held a dominant position in the market for the
29 transportation and partial treatment, via the Ashgrove system, of water abstracted
30 from the Heronbridge extraction point for supply to Shotton Paper and Corus".

31 So it was quite a complicated market definition with two services, transportation and partial
32 treatment of industrial water. Can you see that?

33 A Yes.

34 Q If you then go to para.40, on pp.12 and 13, you will see how Ofwat, as it was, set about

1 analysing the excessive pricing issue because the matter was first of all considered by
2 Ofwat. You will see that there was a sequence of elements that were considered by Ofwat
3 which are in the bullet points going all the way down, so, for example, including partial
4 treatment, management of lagoons, common tariff services, a number of separate issues.
5 They were all considered, were they not? Can you see that? (After a pause): Can you see
6 that?

7 A I can see but, as I said, I am not familiar with the case. There is a long list of them. If you
8 want me to read this properly then I am happy to do it properly, but I need time to do it
9 properly. If you want me to just skim it, I can skim it. I would appreciate some guidance.

10 Q All you need to see is that there are a sequence of services all together.

11 A I can see a set of bullet points that describe a number of services. I would agree with that.

12 Q Then if you turn to para.49 on p.16, you will see that a summation was done in relation to
13 costs in relation to a number of these elements taken separately and then totals at the
14 bottom. That is correct, is it not?

15 A What are you asking me to confirm?

16 THE PRESIDENT: What is the point you are seeking to put on this, which you say is just an
17 example?

18 MR. THOMPSON: What I am seeking to put, if I may ----

19 THE PRESIDENT: Because it might help Dr. Houpis to understand the question.

20 MR. THOMPSON: This is an exercise to determine unfair pricing conducted initially by Ofwat
21 and then by the Tribunal, and the point I am making is that this was a complex, multi-
22 element set of services, not only transport and distribution but also a number of elements
23 within transport and distribution. That is clear, is it not?

24 THE PRESIDENT: I think we can see that, yes.

25 MR. THOMPSON: Then the conclusions of the Tribunal are at 197 on p.61, and I think this is
26 the point that your legal team put by comparison to the present facts, para.197, and you will
27 see that there are percentages set out which are the percentages by which the First Access
28 price receives costs and then there are numbers there, 46.8%, 68.1% and 70.6%. The point I
29 am making is that in a leading case on excessive pricing the relevant issue is the overall
30 price on the relevant market. That is how the Tribunal set about it, did they not?

31 A I think you make a conclusion -- I am sorry.

32 MR. PICKFORD: Sir ----

33 THE PRESIDENT: I am not quite sure it is clear to ----

34 MR.PICKFORD: I hesitate to interrupt to but this seems to be simply a point of legal submission

1 on a case that Dr. Houpis was not involved in. It is not clear to me that he can really be
2 fairly asked to answer these questions. And I am not clear that it actually helps anyone.

3 THE PRESIDENT: Mr. Thompson, if really you want Dr. Houpis to express a view of what is
4 being done here, then he has got to be given time to read what is a very complicated
5 judgment. If your point is that in an unfair pricing case one is looking at the extent of the
6 overcharge, if that is the point, against a measure of cost then you can put that point more
7 simply, I think.

8 MR. THOMPSON: I can put it in the abstract, but I thought it might be easier to make it more
9 concrete. I think since you are familiar with telecoms and post, there are obviously different
10 requirements of different customers for different elements of the service. That is true, is it
11 not? It is true generally. For example, the price of a stamp will be the same for people
12 living next to the post office or in Scotland, and so there will be different requirements, will
13 there not?

14 A I'm not sure I understood the question. Are you talking about – sorry, could you repeat the
15 question, please?

16 Q In the regulated sector where there are prices for a service they will be made up of
17 components which will be of more or less value to different customers for those services.
18 That is correct, is it not?

19 A I'm afraid you have to explain this further. What do you mean by service, what do you
20 mean by components, tell me exactly what you mean by customers.

21 Q We have illustrated a case here where there was a composite service made up of a number
22 of different components, and different customers would have had different needs. The
23 example is there, but you would be more familiar in the postal service or in the telecoms
24 service. Indeed in this case, although there is a standard rental charge, in practice the length
25 of fibre or duct will not be the same for every customer; it will vary. You look at the price
26 for the service, not at the individual circumstances and individual customers. That is
27 correct, is it not?

28 A I'm afraid I'm not following.

29 Q If I put it at its most general, if you are making a finding in relation to the price for service
30 you carefully define the market, you have found market power on a particular market. Then
31 if you are making a finding of excessive pricing you are looking at the prices for the service
32 on that market. That is correct, is it not?

33 A If it's an absolute question as to whether, when you're looking at the relevant market you
34 have to find your relevant market, are you saying that relevant market includes not just one

1 service but many services? Is that the point you are making?

2 Q If the service is a composite service --

3 A What do you mean by a composite service? Could you give the example for a stamp? A
4 letter is not a composite service. What exactly do you mean by composite service?

5 Q If you put a stamp on you are buying a selection of services to get your letter from your
6 house to somebody else's house, or your business to somebody else's business, are you not?

7 A I would not describe that as a set of services because there is an end to end provision of a
8 service which is a letter being sent from one party to the other. I know that to deliver that
9 service you may need different elements within the supply chain. If that's what you mean,
10 then that is correct.

11 Q If you are looking at whether the price of the stamp is excessive, you are looking at the
12 overall set of services, are you not?

13 A Again, I'm trying to do my best.

14 THE PRESIDENT: I am not sure I follow this. Is your point that costs against which you are
15 determining whether something is excessive will have a single price but the costs of
16 providing the service will vary greatly as between one customer and another? Is that your
17 point?

18 MR. THOMPSON: There is that point, but the overall point is that the costs for the service, or the
19 question of whether or not your price is excessive as against your costs, will be looked at
20 the level of the service, not at the components? You have defined a market for water, or
21 stamps, or whatever it is, sorry, postal services or whatever it is, and you are looking at the
22 price as against the cost of that service. That is correct, is it not? That was the whole point
23 of the market definition exercise: to set up what was the relevant issue to look at. That was
24 the purpose of the market definition exercise, was it not?

25 THE PRESIDENT: If one is deciding whether the price of a service is excessive, then you look at
26 the price of the service.

27 MR. THOMPSON: As against the cost of that service.

28 THE PRESIDENT: Yes.

29 MR. THOMPSON: It is a very straightforward point, and it may be of significance to this case.
30 That is why I am making the point.

31 THE PRESIDENT: So whether that is true, whether it is a composite service or a single service,
32 you look at the price of the service --

33 MR. THOMPSON: Overall.

34 THE PRESIDENT: If that is the price that you are deciding is excessive?

1 MR. THOMPSON: Yes.

2 THE PRESIDENT: Yes, that seems an elementary proposition.

3 MR. THOMPSON: Yes, indeed it was. That was why I was hoping that Dr. Houpis would agree
4 with me.

5 A It's a terminology with which I have an issue; if you're saying to me if I'm going to look at
6 whether Coca Cola is pricing excessively, will I look at the bottle separately from the
7 production of the drinks? No, I am looking at the service, and the service when I buy a
8 drink includes everything that goes with that. If that's the question I think that the answer is
9 we would look at the cost of producing the service for which the allegation is made that it
10 might be priced excessively, yes.

11 Q Sometimes it is a simple matter and sometimes it is complicated. I simply showed you
12 *Albion* as an example of where it was.

13 A Sure, yes.

14 Q Can we now look at the question of what economists would call, or certainly lawyers
15 pretending to be economists would call, the theory of harm. That is also crucial to any
16 competition law analysis, is it not?

17 A It's not crucial, but I think it is an element of the analysis, yes.

18 Q Excessive pricing and margin squeeze have quite different theories of harm, do they not?
19 One is broadly exclusionary and one is broadly exploitative or concerned with the excessive
20 prices going through to consumers. That is elementary as well, is it not?

21 A Not quite. I think margin squeeze you can have both, because it depends on how the margin
22 squeeze is effected, actually. So you can have margin squeeze and exploitation at the same
23 time. It is also possible that you can have a margin squeeze with a different theory of harm
24 of excess prices.

25 Q Yes. Can we now look at core bundle B p.69. That is the Determination again, para.8.57:
26 "If cost orientation were assessed on an aggregated basis, this would allow BT to
27 charge a high price for service A (relative to costs), and a low price for service B
28 (relative to costs). While in aggregate prices might be similar to costs, those who
29 bought relatively more of service A would be disadvantaged relative to those who
30 bought relatively more of service B, and both groups of CPs would face distorted
31 price signals."

32 That is, as it were, a little mini theory of harm of its own about price distortions, is it not?

33 A This is one example, yes.

34 Q Would a hypothetical concern of that kind be a recognised form of market abuse?

1 A Sorry?

2 Q Would that be a recognised form of market abuse: setting prices so that one type of
3 customer was in a better position than another type of customer? For example, setting a
4 price for a stamp so that somebody in Scotland was better off than somebody in London?
5 Would that be a recognised form of market abuse?

6 A Sorry, you have to be more specific. In general no, but if you are in a dominant position
7 then there is a risk, then you could potentially have a discrimination allegation. Is that your
8 point?

9 Q Yes, it is a different theory of harm from excessive pricing in any event, is it not?

10 A I am trying to understand so I can answer your question.

11 Q It is a very simple question; it is a different theory of harm from excessive pricing, is it not?

12 THE PRESIDENT: I am not sure it is, Mr. Thompson, quite such a simple question. It depends
13 what one means by theory of harm, and in particular what, in terms of the harm that results.
14 There are different ways of leading here, certain consumers paying higher prices. This is
15 dealing with discrimination. I think that is the point you make, but that is being put now,
16 but the resulting harm from discrimination, what harm it causes in market terms, can be a
17 more complicated question. If you would like Dr. Houpis to address the Tribunal on the
18 harm that would cause if this were to happen, then yes, you can ask him.

19 MR. THOMPSON: I am trying to ask him fairly focused questions to make some progress. Dr.
20 Houpis is agreeing with me.

21 THE PRESIDENT: No, he was not prepared to commit to that.

22 MR. THOMPSON: Can I move on and ask another question. This concern could arise
23 independently of any concerns over excessive pricing, could it not? It could arise within the
24 DSAC limit, or indeed within your FAC limit, could it not?

25 A Could you clarify which concern you are talking about?

26 Q We have just read 8.57. There is nothing about the price level; it is simply the difference in
27 price between A and B. Just to help you, can you turn to your third report.

28 A Shall I put the bundle with the water case away?

29 Q Yes, we do not need that any more, thank you.

30 A My third report is tab?

31 Q Tab 10 para.3.12. You set out a table there and just above it:
32 "DSACs of WES/BES services were on average approximately 2.4-2.7 times the
33 corresponding DLRICs in the 2007-09 period (see table below). Ofcom's proposal
34 therefore already affords BT a very significant level of pricing flexibility."

1 That is correct, is it not?

2 A That is correct.

3 Q Were you present in court when Mr. Harman gave his evidence?

4 A I was.

5 Q Do you remember his 10 10 example going to 7 11? On this evidence, presumably you
6 could set your connections at 4, the DLRIC, and your rentals at 10, the DSAC. Is that
7 correct? You said that the DSAC is about two and a half times the DLRIC. That is correct,
8 is it not? That is what you say here?

9 A You are using a lot of different services. Did you say DLRIC for connections and DSAC
10 for connections, or are you saying about different services?

11 Q This is taking connections at 4 and rentals at 10, which is I think the example that Mr.
12 Harman gave but modified to your FAC. You could set the connection at DLRIC and the
13 rental at DSAC, could you not?

14 A Under the cost orientation obligation, if you were to be compliant with that obligation, then
15 in relation to the connection charges you could price no lower than DLRIC and no higher
16 than DSAC. DLRIC you could go down to 4, as you say.

17 Q All the other ones, you could price connections at 10 and rentals at 4?

18 A If these are the DLRICs and the DSACs, yes.

19 Q Yes, so as far as this concern at 8.57 is concerned, you could have some very considerable
20 leeway for BT to achieve its purposes well within the cost orientation obligation, could you
21 not?

22 A I am sorry, which purpose are you talking about now?

23 Q The concern here is if you charge relatively more for Service A, and I think this is assumed
24 to be connection, and less for B, or vice versa, then you would create some form of
25 distortion, distorted pricing. That is the concern, is it not?

26 THE PRESIDENT: In 8.57, in that paragraph. That is what you mean?

27 MR. THOMPSON: Yes.

28 THE PRESIDENT: In the paragraph in the Determination.

29 A So if you are saying that Ofcom's statement in 8.57 is that if you aggregate services and
30 therefore you are looking at the service together, you have flexibility in terms of the way
31 you recover the cost, then that is correct, yes.

32 MR. THOMPSON: I am saying within the DSAC limb BT could achieve exactly the problem
33 that 8.57 is concerned about by pricing one at DLRIC and the other at DSAC. That is
34 correct, is it not?

1 A Well, I am not sure I understand the problem that you are talking about. What is happening
2 is that Ofcom has come to the view that in relation to individual charges, i.e. connections
3 and rentals (and that is with all services, not just connections and rentals, but connections
4 and rentals as well), it is desirable to have a certain amount of flexibility in terms of where
5 individual charges can be in order to facilitate one objective, which is the more efficient
6 recovery of fixed and common costs.

7 Q Yes.

8 A Yes? Okay. So if, as a result of that, it will be the case that the price for connection, the
9 price for rentals will not all be at the same level and therefore the standards that have been
10 used is the DLRIC in terms of the floor and the DSAC in terms of the ceiling. The
11 implication of that is that if customers that buy more of one and less of the other then they
12 would be paying different amounts, but that is correct.

13 Q All I am saying is, if this was Ofcom's concern about pricing then there is a problem
14 because, on your evidence, you could set connections at 4 and rentals at 10 or vice versa,
15 could you not?

16 A I am sorry, could you repeat the question?

17 THE PRESIDENT: I think what is being said - correct me, Mr. Thompson, if I have
18 misunderstood it - but let me try and help, para.8.57 of the Determination expresses a
19 concern that Ofcom articulates about BT's pricing, and the consequences of applying cost
20 orientation by aggregating connections and rentals, and says that would have this potential
21 adverse consequence that it would disadvantage some customers more than others. That is
22 the concern I think they express.

23 A That it could potentially, yes.

24 Q Yes, and that is a reason therefore not to aggregate connections and rentals. There may be
25 other reasons but that is a reason that is put forward in 8.57.

26 MR. THOMPSON: And the concern ----

27 THE PRESIDENT: Just a moment. What they are doing in this section is analysing Ofcom's
28 view, in response to the various arguments that had been put forward and one of those
29 arguments was BT's argument to Ofcom, as to this Tribunal, that they should be aggregating
30 it, and Ofcom is saying, as I understand it, "If we were to aggregate this would have this
31 consequence".

32 A Understood, yes.

33 Q And that would not be a good thing, put crudely.

34 A Potentially, yes. I understand.

1 Q I think that point that Mr. Thompson is putting to you is what Ofcom has done is to say
2 disaggregate, so it is a cost orientation for rental and a cost orientation for connection, but
3 both of those are put at a level of DSAC as the ceiling and therefore it is, under that regime,
4 also quite possible for BT to charge a higher price for a connection and a lower price for
5 rental and still recover its costs because DSAC is only a ceiling, and he gave the example of
6 how they could do it. Have I followed it? That was the point you were putting?

7 MR. THOMPSON: That is correct. I am simply looking at Dr. Houpis' ----

8 THE PRESIDENT: That was the question and therefore it has not, in fact, addressed the problem
9 and they are no better off than if they had been aggregated.

10 A Understood. So I think the issue is that as also this is subject to the DSAC ceiling that the
11 reality is that if you were able to aggregate, then under the test it would be possible to price
12 an individual service above DSAC. That is the whole point. That is why when Mr. Harman
13 operates his test that the amount of money goes down. So I think although the concern is
14 there, under aggregation it is more severe. So I think Ofcom's statement seems reasonable.

15 Q What you are saying is that the concern is still there but it is more severe if there is
16 aggregation?

17 A Yes, and I appreciate that the question is more specific but, as I said, there is a certain
18 amount of flexibility required in order to achieve the objective of giving the company
19 enough room to be able to recover its costs efficiently. I accept that that is not completely
20 costless because there will be different customers buying different services and therefore
21 they might be paying a different charge. However, that is part of the objective. The idea is
22 that you are trying to recover more of the fixed and common cost from the demand that is
23 relatively more inelastic. That is the whole idea of how allocative efficiency is improved by
24 allowing the company to recover relatively different proportions of fixed and common
25 costs, is that you explore the elasticities, the difference in elasticities. As a result, by
26 implication is if those customers that have a more inelastic demand they will make a
27 different contribution from those that have a more elastic demand. It is part and parcel of
28 the same objective. I do not think that in itself is actually a detriment or a harm. It is
29 actually supporting the improvement in allocative efficiency.

30 MR. THOMPSON: Can I ask another question, which is imagining BT engages in this practice,
31 if the beneficiary of it is BT itself, if somehow BT got a benefit from setting a price, that
32 would be incompatible with its equality of input obligations and it would be incompatible
33 with its non-discrimination obligations, would it not?

34 THE PRESIDENT: Setting a price?

1 MR. THOMPSON: That somehow doing this, if one of these characters was BT, that would be
2 contrary to its obligations under the undertakings and under non-discrimination, would it
3 not?

4 MR. PICKFORD: That seems to be a pure legal question.

5 THE PRESIDENT: That is a legal question, I think. That is for submission.

6 MR. THOMPSON: I think it is a strong part of Mr. Houpis' case that BT might benefit from this
7 practice.

8 THE PRESIDENT: You mean on the aggregation of connection/rental point?

9 MR. THOMPSON: Yes.

10 THE PRESIDENT: That it would work in BT's favour?

11 MR. THOMPSON: Yes. It is not very clear from this paragraph. It looks more natural that the
12 benefit was simply one of BT's customers as against another, so possibly Ms. Rose's clients
13 as against Mr. Pickford's.

14 A Yes, my argument, the argument that I made, is, if it is correct, that one of the options that
15 would be open to BT -- this is not about discriminating between BT's downstream arm and
16 communications providers, this is in relation to different communications providers, and the
17 argument that I made is that this additional flexibility that aggregation would provide would
18 make it more possible, would increase the ability that BT would have to structure the prices
19 in a way that would be more detrimental in relation to one communications provider
20 compared to another communications provider. That is correct. My understanding of undue
21 discrimination is that it is a legal question but my understanding is that this primarily, the
22 objective is to make sure BT does not discriminate in favour of its downstream arm against
23 other communication providers.

24 Q Yes, but look at the second case, I have given you the example of the stamp and equally you
25 set the price, connections and rentals, Ms. Rose's clients say "Terrific", Mr. Pickford's say,
26 "Boo, that is awful", would that be a recognised form of abuse just to set a price which some
27 clients like and some clients do not?

28 A My point is that under the current framework, under this aggregation, BT has a certain
29 amount of pricing flexibility and the reason there are limits, the pricing flexibility can be ...
30 i.e. it has to price individual services no lower than DLRIC and no higher than DSAC, is
31 because there is recognition that the structure of those prices could be used to distort
32 downstream competition. If that was not the case then the structure of prices would not be
33 of a concern to Ofcom, but it is the case. Given that, the question then is in the specific
34 context how can this additional flexibility that BT would have in terms of the structure of

1 prices, how could that be used? I have provided a number of ways in which BT could use
2 that flexibility for trying to distort downstream competition, and one of those ways would
3 be to try and favour, if you want, or disadvantage rather, one communication provider
4 relative to another communication provider if it considers one to be a potentially more
5 threatening competitor. That is the point I am making.

6 Q Even if that is a concern, just going back to our issue about excessive pricing, it would be a
7 completely different concern over excessive pricing, would it not?

8 A Over excessive pricing?

9 Q Yes.

10 A Correct.

11 Q Were you here when Dr. Maldoom gave his evidence?

12 A I was.

13 Q Do you remember the section where he talked about the "baking in" of costs of this issue in
14 2004 or 2008 market reviews? Do you remember that?

15 A I remember the term but I cannot remember the context, I am afraid.

16 Q As I understood the evidence, Dr. Maldoom was saying that he would have expected some
17 indication from Ofcom that there was a concern about the relative prices of connections and
18 rentals, if that was indeed part of the 2004/2008 regulatory regime. Do you accept that that
19 was what he was getting at? He was thinking why wasn't there any sign of it in the 2004
20 review or the 2008 review?

21 A As I said, I do not recall. If you want me to have a look at the transcript then I can give you
22 my view.

23 Q I do not think you said and I do not think Sky has said, or TalkTalk have said, that there was
24 any such sign in the 2004 review or the 2008 review. There is nothing in your evidence
25 about a concern about price distortion re connections and rentals. That is not something in
26 the reviews, is it?

27 A As I said earlier, my understanding of the way in which the cost orientation operates, and I
28 think I was asked by Mr. Saini, one of the objectives is to restrict the flexibility that BT, as a
29 dominant company, has in terms of structure of prices. In that sense I am not quite sure
30 why it is necessary to have some special alert in the market review. You have different
31 charges. You are a regulated company. You are aware that the structure of charges is of
32 concern to the regulator. You are clearly aware of that and you are also clearly aware that
33 the floors for those prices, for the individual charges, are DLRIC and there are ceilings at
34 DSAC. Given that, I think the implication I would draw is I do not think it is necessary to

1 have some special alert. That is why the floors and the ceiling are there, to prevent you
2 from behaving in that way.

3 Q But so far as you are aware, there was no indication in the 2004 and 2008 review that this
4 was a concern?

5 A I do not recall. I haven't looked at that in detail. I do not recall whether there was an
6 indication or not.

7 Q Can you turn to core bundle E, tab 14, and go to p.158. Just to give some context to this, I
8 think you will recall that the context to this is that in relation to AISBO services or Ethernet
9 services, the introduction of a charge control was meant to be dealing with issues that had
10 arisen in the previous period over cost orientation, or at least that was part of the motivation,
11 was it not?

12 A I'm not sure if this is a question or a statement. Is this a statement or a question?

13 Q Do you disagree with it?

14 A What are you asking me to disagree with? What is the question?

15 Q Ofcom introduced charge controls in 2008?

16 A Yes.

17 Q And that was to deal with, on the low bandwidth market, historic problems over pricing.
18 That was what it was about, was it not?

19 THE PRESIDENT: Is that your understanding?

20 A My understanding is that it was aimed to deal with the fact that BT was earning excessive
21 returns in the relevant market, yes.

22 MR. THOMPSON: Yes. The approach that they adopted to setting the controls, one can see at
23 5.90 and 5.94. They are passages we looked at before.

24 A Which paragraph?

25 Q 5.90, first bullet point.

26 A Just to be clear, is this asking about the 1 Gbit/s of the BES service - is that the paragraph,
27 just to make sure?

28 Q Yes, that is right, and Ofcom says:

29 "We have estimated the required price cuts by

30 Comparing the aggregate connection and rental prices over the contract life of an
31 AISBO circuits (assumed to be three years) to the aggregate of our adjusted DSAC
32 values for these services."

33 Then it goes on and it says:

34 "We note that this consideration is without prejudice to cost orientation."

1 You will remember, I was talking about the "baked in" aspect that Dr. Maldoom had said,
2 and that there was no indication of a concern in the 2004 and 2008 Review. This is
3 evidence of the converse, that Ofcom was not concerned, is it not, because they aggregated
4 connections and rentals so that they were not concerned about this issue. That is why they
5 aggregated them - that is correct, is it not?

6 A I'm not sure I'm following you. Do you mind repeating the question, please?

7 Q If there had been concern, they would not have aggregated connections and rentals. That
8 would not be consistent with a concern about that, would there?

9 A I think the question you're asking me is in relation to one service, not across the whole
10 services: does the fact that Ofcom, when it came to decide on the price control, it made a
11 starting level adjustment, and for that starting level adjustment it looked at the connection
12 and rentals together. You're saying, doesn't that mean that actually Ofcom is not concerned
13 about the structure of prices? I think that's way too far. I wouldn't read that into it at all.

14 Q Not generally, but in relation to connections and rentals?

15 A I am talking about connections and rentals.

16 THE PRESIDENT: I think what is being put is: do you agree with the suggestion that what
17 Ofcom is doing here is inconsistent with a concern about connection and rentals
18 individually?

19 A I do not believe there is a huge inconsistency. Ofcom needs to do a starting level
20 adjustment. In doing that starting level adjustment, it needs to come with some
21 methodology to do it. This is not across the board. Ofcom has not given a view as to the
22 other levels of connections and rentals. In order to do that, it needed to find a practical way
23 of doing it, and the practical way that it decided to do was to combine them, just as a one-
24 off. As I think has been stated by Ofcom, and it is the case, Ofcom generally tries to do a
25 very small number of adjustments when it sets price controls, so this is a very special, I
26 think, issue.

27 MR. THOMPSON: Can we move to a different topic, which is the nature of your client's
28 complaint in relation to BT's prices. Could you take the witness statements, core bundle C,
29 tab 8. It is p.7, paras.24 to 29, where Mr. Higo sets out his complaints about BT's pricing
30 and their detrimental effects.

31 A Yes.

32 Q The first one is a complaint about higher backhaul costs having an effect on the unbundling
33 programme.

34 A Yes.

1 Q The second about high backhaul prices leading to lower profits. The third is Sky's
2 investment and innovation. The fourth is about Sky's competitors and their input costs, and
3 the fifth is about BT Retail and having less competition.

4 A Yes.

5 Q There is nothing about price distortions because of the balance of charges, is there?

6 A This is preceded by para.24, which talks about high prices.

7 Q They are complaining about high prices, they are not talking about price distortions or price
8 signals. That is not what they are complaining about. It is all about excessive pricing, is it
9 not?

10 A I must say, in this specific paragraph, the complaint I read is about high prices. Whether
11 Sky and TalkTalk have also complained about the structure of prices, I'm not fully aware.
12 But you're right, in this paragraph it is about high prices, yes.

13 Q Yes, exactly. If one looks at tab 10, para.16, again there is complaint about the overcharge
14 for BES services, detrimental effects on investment and competition and the viability of
15 local exchanges, TalkTalk's cash flow, lower profitability and again disadvantages against
16 other CPs who did not pay the BES charges. So again, there is nothing about price
17 distortions, is there?

18 A Well, let me just clarify a point, because I think I have made the point in my report, but it's
19 worth clarifying. In relation to BES services, allowing greater flexibility for BT for the
20 pricing of BES services could actually lead to higher prices being faced overall by the
21 communication providers that buy the BES services, such as Sky and TalkTalk. Although it
22 is presented as a structure of prices issue, effectively if aggregation was allowed then the
23 implication is that where BT found that the profit maximising prices for BT for connections,
24 let's say, were below DSAC and the profit maximising prices for rentals were above DSAC,
25 that would be in relation to its profit maximising prices, okay. In other words, that would
26 be a set of prices which could be detrimental to downstream competition, then under the
27 Ofcom test - sorry, under the disaggregate approach they would not be able to price rentals
28 above DSAC without being found to have overcharged. Under the aggregate approach,
29 which is proposed by BT and Mr. Harman, they would be able to price higher to the extent
30 the connection price was below DSAC. Therefore, the greater flexibility in relation to BES
31 services would actually lead to BT being able to charge higher prices, it's not just about the
32 structure.

33 Q There is nothing here about the structure and price signalling and distorted incentive. There
34 is nothing about that, is there?

1 A As I've just explained, if you aggregate the services that provides greater flexibility. The
2 greater flexibility will give higher prices, and I think both Mr. Higo and Mr. Heaney said
3 that higher prices would be detrimental.

4 Q I fully understand that your clients are enthusiastic about maximising their return from these
5 proceedings and lowering prices generally. I can see that. In terms of what I was asking
6 you about, distortion, there is nothing about that in that evidence, is there?

7 A There is no direct statement about the structure of prices from Mr. Higo and Mr. Heaney, I
8 agree with that, yes, as far as I've seen, and I haven't read all the statements. I'm not sure if
9 someone has else has made a statement. In the places you've asked me to read them, there
10 isn't a statement about structure of prices, yes.

11 Q Can you turn to your third statement.

12 THE PRESIDENT: Do we want to keep bundle C?

13 MR. THOMPSON: Not at the moment, no, I think we can put C away.

14 THE PRESIDENT: We started at ten, and we need to take a short break at some point.

15 MR. THOMPSON: We could certainly take a break now?

16 THE PRESIDENT: Do you know how much longer you have?

17 MR. THOMPSON: I am afraid Dr. Houpis is the principal witness for the other side, as it were,
18 and that he covers a lot of issues. I have still the issues of FAC and DSAC and interest,
19 which have very large price tags attached to them as against my client.

20 THE PRESIDENT: He is the sole witness on FAC and DSAC.

21 MR. THOMPSON: Yes.

22 THE PRESIDENT: Because it is only in that appeal. So it is important that that is covered as
23 regards the other matters. It is an intervention, but interest is also covered.

24 MR. THOMPSON: Not by the experts. I do not think Mr. Holt deals with the issue of interest.

25 THE PRESIDENT: Yes. How much longer do you expect to be? It is important you cover
26 particularly the FAC and DSAC point because nobody else addresses that. How much
27 longer do you anticipate being?

28 MR. THOMPSON: I think at the rate we are going I will certainly be until lunchtime. I do not
29 want to make a gripe, but Mr. Pickford, I think, cross-examined Dr. Maldoom for over a
30 day, and that was with Mr. Saini before and Ms Rose after.

31 MR. PICKFORD: It was not actually a day, but I do not want to get into an argument about it.

32 MS. ROSE: It is not really about whether it is a gripe or not, it is simply about ----

33 THE PRESIDENT: I am just trying to look at the timetable because of Mr. Holt's practical
34 difficulties which you signalled yesterday.

1 MS. ROSE: Obviously I do not cross-examine Dr. Houpis, I had no idea how long he was going
2 to be, so I did ask the other counsel involved for their estimates so that we could make a
3 decision. If necessary, we could have called Mr. Holt before Dr. Houpis. I was assured by
4 Mr. Thompson, amongst others, that Dr. Houpis would be finished before lunch today so
5 there would be time for Mr. Holt. I do not know how long Mr. Thomas or the other counsel
6 are going to cross-examine Mr. Holt.

7 THE PRESIDENT: On the chart I have got nobody else is going to cross-examine Mr. Holt, it is
8 just Mr. Thompson.

9 MS. ROSE: I think it is actually going to be Mr. Read and Ms. Lee.

10 THE PRESIDENT: It is only BT.

11 MS. ROSE: Perhaps the point is simply that if BT have today to finish this witness and Mr. Holt,
12 it is up to them how they divide their time. The alternative is we could interpose Mr. Holt at
13 two o'clock.

14 THE PRESIDENT: I think that you can consider that at lunchtime. I am not very keen on
15 Mr. Holt being interposed, if that can be avoided. I do not know how long Ms. Lee and
16 Mr. Read are expecting to cross-examine Mr. Holt for. He has got only one report. I have
17 said we will sit until 5, so if that commences at 3 o'clock, but there is maybe some re-
18 examination of Mr. Holt, then I think your colleagues consider that adequate then you can
19 go on. Is there anyone else cross-examining Dr. Houpis? I think not, is there? So it is just
20 re-examination and some questions from the Tribunal, so then you can go on until 2.30. But
21 if Mr. Read and Miss Lee think it is going to take considerably longer then we have a
22 problem. It was signalled yesterday that Mr. Holt is not available tomorrow?

23 MR. THOMPSON: Yes, Sir.

24 THE PRESIDENT: I think we will rise for 10 minutes now and you can discuss the position with
25 your colleagues and what needs to be done with Mr. Holt. Areas that are covered also by
26 Mr. Holt and, indeed, also by Mr. Holt and, indeed, Mr. Myers you do not have to go into
27 quite so thoroughly with Dr. Houpis.

28 MR. THOMPSON: Yes, I will obviously think about that.

29 THE PRESIDENT: The area that I think is very important that you go into is the FAC test and
30 the interest point to some extent.

31 MR. THOMPSON: Yes.

32 THE PRESIDENT: We will come back at just after five to 12.

33 (Short break)

34 THE PRESIDENT: I think what we will do, Mr. Thompson, is let you continue until lunch and

1 then consider whether, indeed, on the progress you have made, it is necessary to interpose
2 Mr. Holt because if necessary Dr. Houpis can spill into tomorrow but we will then have to
3 look at the effect on the other two witnesses, but it is clear Mr. Holt has to get away today.

4 MR. THOMPSON: I think probably the best thing is for me to make what progress I can.

5 THE PRESIDENT: Yes, and see where we have got to at lunch time.

6 MR. THOMPSON: Just to say to the Tribunal what I was planning to do was to cut down on the
7 further points I had on connections and rentals because that is an issue that Miss Lee will be
8 exploring with Mr. Holt and which obviously the Tribunal has had quite a number of
9 submissions ----

10 THE PRESIDENT: And it is going to be explored with Mr. Myers, is it not?

11 MR. THOMPSON: And has been explored with Mr. Harman in some detail.

12 THE PRESIDENT: Yes, one does not have to explore it with everyone. On the interest point Dr.
13 Houpis put in a very short report just dealing with incentive on BT.

14 MR. THOMPSON: He also dealt with it in responsive evidence in his fourth report.

15 MR. PICKFORD: Sir, I have not asked Dr. Houpis obviously because I have not communicated
16 with him, just to check that Dr. Houpis is actually available tomorrow.

17 THE PRESIDENT: Let us go to lunch and then see where we are.

18 MR. PICKFORD: Yes.

19 MR. THOMPSON: (To the witness): Just taking this quickly, your third report, para. 3.26.2 on
20 p.18. The second sentence:

21 "If, however, as Mr Harman argues, informed purchasers examine the overall
22 connection and rental payments over the lifetime of a contract, it is not clear why
23 the structure of charges for connections and rentals should affect the rate of roll-out
24 of LLU services, as BT argues."

25 You appear to be saying there presumably Sky and TalkTalk are informed purchasers, is
26 that correct?

27 A Yes, the people buying those services would be informed purchasers quite clearly.

28 Q You seem to be accepting the premise that informed purchasers do not worry about the
29 structure of charges. Is that right?

30 A No, that's not what I am saying at all. What I am saying is - it is Mr. Harman that made that
31 claim, not me - if Mr Harman says because of whole life costing the structure doesn't matter
32 then I think that is inconsistent with at the same time trying to argue that actually the
33 structure does matter because it means you can accelerate the take-up of services
34 downstream. My own view is that the structure does matter.

1 Q The reality here is that I think on your case connections were low relative to rentals, and on
2 the facts rentals were continually falling, so how could that have made any difference to
3 your client?

4 A My point I think is a simple one. Mr. Harman has made the calculation. His calculation is
5 that the amount that would be owing is, I think, around £10 million less. In my view for
6 those communication providers that purchased their services that is a direct result of the
7 prices of rentals being above DSAC, the price of connection being below DSAC - this is
8 over the relevant period - and, as a result of that, by knocking off some of the excess of
9 revenues over DSAC rentals for BES, he is able to reduce the overpayment for BT. To me
10 it's very clear what the impact is on TalkTalk and Sky.

11 Q I can see from a money point of view you do not like it, but there is nothing about the
12 distortions point that flows from there, is there? It is nothing to do with distortion, it is just
13 you want more money for your client?

14 A I don't agree ----

15 THE PRESIDENT: Well, they are not strictly his client, the party has instructed him.

16 MR. THOMPSON: Yes, I am sorry, I perhaps took that a little hastily, but I am trying to move
17 on.

18 A The reason, I think it is very clear. The prices are higher than they would otherwise be as a
19 result of the price being higher, that means that the rental prices, to the extent that they get
20 passed on, rental prices would be higher than they would otherwise be and the profits of
21 communication providers who buy those services are lower than they would otherwise be.
22 Therefore, consumers would be worse off and ... competition would be harmed, so I'm not
23 sure what you're saying that that particular additional flexibility would not have an impact
24 on both consumers and communication providers that purchase those services.

25 Q Can we now look briefly at the issue of duration. The starting point is the Determination
26 or Decision, which is core bundle B, p.423. (After a pause): Do you have the numbers in
27 boxes, Dr. Houpis?

28 A 15.2?

29 Q Yes. You will see the numbers against BES 100 and 1000 both for Sky and TalkTalk, and
30 you will see the relationship between those four numbers in the top left hand corner and the
31 totals at the bottom both for TalkTalk and Sky and at the side as against the grand total at
32 the bottom?

33 A Yes.

34 Q So those four numbers are very significant to the whole case, are they not?

1 A So by the four numbers you mean the numbers on the top?

2 Q The Sky/TalkTalk figures for BES100 and BES 1000?

3 A Yes.

4 Q Can we now look at Mr. Coulson's report, which is at core bundle D, tab 14?

5 A Yes.

6 Q Pages 32 and 33. You will see that there is a Ceased Circuit Analysis for BES 1000 and
7 BES 100, do you see that?

8 A Table 5.2 and table 5.3?

9 Q Yes.

10 A Yes, I see those.

11 Q The numbers are said to be confidential, but can you see the Sky and TalkTalk lines for
12 BES1000 and if you go across, if you look at the column: "ceased between 2-3 years" and
13 "ceased between 3-4 years" do you see them?

14 A Yes, in table 5.2?

15 Q Yes.

16 A Yes.

17 THE PRESIDENT: You are asking Dr. Houppis to look both at the BES 1000 in 5.2 and the BES-
18 ----

19 MR. THOMPSON: If we start with the BES 1000 and go across to Sky and TalkTalk. Again,
20 these are allegedly confidential figures so I will not say what they are, but I think it is
21 striking the proportion of Sky and TalkTalk BES 1000 circuits that are between two and
22 four years if you put it in that way?

23 A So, what do you mean by "striking"?

24 Q As against the total. If I am not going to name the numbers then I am simply ----

25 A "Striking" as in relatively high, we can say that?

26 Q Yes, I think we can say it is a high proportion. Do you see that?

27 A To be honest with you, is there a column that shows the percentage because I can't mentally
28 add up those columns and divide them by the total? I can see they are relatively big
29 numbers, you are right.

30 Q If you go across the TalkTalk columns you see that when you get to two to three years and
31 three to four years they are strikingly higher than any other figure in the row, are they not?

32 A I am a little bit constrained now with the confidentiality because I would say something
33 else which I am not sure if I can mention or not.

34 THE PRESIDENT: Never mind what else you see, on the question you are asked you can see the

1 total for TalkTalk, the number of circuits, you can see the total Sky number of circuits and
2 then you can see what part of that is accounted for, the circuit ceased in two to four years?

3 A I can see exactly what you said, I am happy to confirm that I can see the numbers.

4 MR. THOMPSON: Likewise, if one goes across to the BES100 circuits, the position is not quite
5 so strong because there are also numbers in one to two years, but also in relation to the two
6 to four years the numbers are again quite striking, are they not?

7 A I am afraid, sir, if I am to answer this question, because I think the implication is being
8 drawn is that the implication of these numbers is that the average duration might be similar
9 and my view is that it is not, based on what I see of these numbers, so I can confirm that I
10 can see those numbers, but I think there are significant differences, so I am not quite sure
11 how I can put that point.

12 THE PRESIDENT: We can see that it is a significant number.

13 MR. THOMPSON: I was simply going to put to you that a large proportion of these two very
14 important circuits are apparently ceased between two to four years, is that fair?

15 A No, it is not.

16 Q It is not fair?

17 A If I look at the numbers - can I talk about the numbers.

18 Q No.

19 A It is difficult for me to answer if I cannot refer to the numbers. I do not think for Sky for
20 BES 100, just by looking, you would say that - I'm afraid I have to make that statement to
21 answer, otherwise I'm not sure how I can answer the question.

22 Q I am not sure about the significance of the colour, is this a Sky/TalkTalk confidential paper?

23 THE PRESIDENT: Mr. Pickford, are you able to help?

24 MR. PICKFORD: I will have to take instructions. Obviously this is a report prepared by Mr.
25 Coulson who is not our witness, I am happy to take instructions now as to the ----

26 THE PRESIDENT: I do not know how the confidentiality was dealt with. I expect that the
27 different parties made requests.

28 MR. PICKFORD: They may have done, I am afraid I was not intimately involved in that so I will
29 have to take instructions on it.

30 MR. THOMPSON: As far as BT is concerned, apparently we are happy to waive the
31 confidentiality but I do not know if Sky and ----

32 THE PRESIDENT: Are you able to park this particular series of questions on this table ----

33 MR. THOMPSON: I think I can make the question. I do not know if Dr. Houpis needs to say
34 anything about the numbers to answer my question but he obviously is free to say what he

1 wants.

2 THE PRESIDENT: What is the question that you are asking because the one that you just asked
3 he felt he would have to.

4 MR. PICKFORD: If it assists, Sir, I have taken instructions and my instructions are that this
5 information is definitely confidential and that neither of the clients want to share it with
6 each other, amongst other things.

7 THE PRESIDENT: Yes. We can, if necessary, exclude everyone who is not in the
8 confidentiality ring but I would rather park it until a convenient time if we are going to look
9 at a detailed analysis of the significance of those figures.

10 MR. THOMPSON: I would simply make the point that a large proportion of the two largest
11 circuits are within the 2 to 4 year band. That was the only point I was making.

12 A I understand the point that you are making but I am finding myself in difficulty answering
13 without making a statement that could be ----

14 THE PRESIDENT: I think if you are wanting to make the statement on the table as to what the
15 figures are that is something that you can see, and we can see. If you want to ask Dr.
16 Houpis about the significance or get him to agree with any proposition about the
17 significance of that then I think he would want to put that in a broader context by reference
18 to the other figures, and that is what is causing the problem. So if it is just seeing what the
19 figures show, we can see them. If you need Dr. Houpis to agree ----

20 MR. THOMPSON: I do not know what Dr. Houpis wants to say so it is not for me to judge.

21 THE PRESIDENT: None of us know what he wants to say.

22 THE WITNESS: I do!

23 THE PRESIDENT: It is a question of if you are asking him to agree with some significance of
24 that. That is the point.

25 MR. THOMPSON: Can I ask my question to see if he is able to answer it?

26 THE PRESIDENT: Yes.

27 MR. PICKFORD: I am sorry, I do not mean to take this any further. It is simply to say that in
28 relation to the generalities of differences between Sky and TalkTalk, etc., my clients cannot
29 see any of these numbers. They do not know the extent to which ----

30 THE PRESIDENT: Your separate clients?

31 MR. PICKFORD: My separate clients do not know their positions relative to each other. That is
32 quite deliberate. We have made sure that they have not shared information effectively.

33 THE PRESIDENT: Yes.

34 MR. PICKFORD: I am slightly concerned, even now, even without referring to specific numbers,

1 we may be getting into revealing information that neither of them actually knows about the
2 other.

3 THE PRESIDENT: Yes. State your question, Mr. Thompson.

4 MR. THOMPSON: I can put it in abstract terms, I think. Insofar as a CP such as Sky or
5 TalkTalk enters into contracts for periods significantly longer than a year, BT's minimum
6 term is irrelevant to its evaluation of the contract. Would you agree with that?

7 A No. I am not quite sure how that directly relates to this but I would not agree with that, no.

8 Q I think that it is certainly common ground with the witnesses we have heard from, I think
9 including Mr. Higho, that the CPs are sophisticated purchasers of Ethernet services and that
10 they engage in whole life costing of the circuits relative to their demand. You accept that,
11 do you not?

12 A I accept that they are sophisticated buyers and that they engage in a degree of whole life
13 costing, yes.

14 Q If it is for a WES circuit it takes into account the needs of the customers and if it is a BES
15 circuit it takes into account the needs of the business that the circuit is going to be used for.
16 That is correct, is it not?

17 A Yes, I would expect that would be the case, yes.

18 Q So if the needs of the business are significantly longer than a year then BT's minimum term
19 is irrelevant, is it not? It is driven by the needs of the business?

20 A Sorry, could you specifically explain what you mean by it is irrelevant in relation to what?

21 Q Let us take it in the abstract. Supposing Sky wants to buy a circuit and it is doing its MPV
22 on a three year project plan. The fact that BT has a minimum term of one year is irrelevant
23 to its decision, is it not?

24 A I am not sure that that would be correct. To put it differently, if the minimum year was
25 longer than one year I would imagine that would be relevant to the decision because you
26 have to take into account what is the commitment you are making when you are engaged in
27 that contract. So I would expect the length of the minimum period to be a factor in that
28 decision.

29 Q If BT's minimum term was five years and your project is three years, that would be relevant.
30 I think that is the point you are making and I agree with you. But if your project length is
31 three years and the minimum term is one year then the minimum is irrelevant. That is true,
32 is it not?

33 A I am coming back to the same point, irrelevant in relation to what? Which decision are you
34 talking about in terms of the relevance?

1 Q If you say it could be relevant, if you could tell us how it could be relevant?

2 THE PRESIDENT: I think irrelevant to the decision to take the circuit you mean?

3 MR. THOMPSON: Yes.

4 THE PRESIDENT: I think what is being said is if a CP wants a circuit for three years and is
5 approaching the decision whether to take that circuit from BT by a whole life costing, the
6 fact that BT has a minimum of one year is not relevant to the CP's decision.

7 A That is correct in the world of certainty, but that assumes a CP knows that it will want the
8 circuit for three years. It is possible they do not want it for more than one year.

9 MR. THOMPSON: They do not make the decision on the basis of something they do not think is
10 going to happen, do they? They do it on the basis of what they think will happen.

11 A I think they will form a view as to what is the expected value over the period they expect the
12 payment, but that will be influenced by the -- at the outcome will depend on the uncertainty
13 around that.

14 Q You will be pleased to hear I have a number of other questions about connections and
15 rentals, but in light of the time and the fact that it is easier to ask Mr. Holt about those
16 questions, we will move onto the FAC and DSAC issue. First of all, just to refresh your
17 memory, Mr. Saini put it to you that what he called "the Houpis test" was objectionable on
18 at least three grounds, and I take the first one and see if you agree with me. He put it to you
19 that it is clear that Ofcom never intended to impose that test. He put that to you, did he not?
20 Ofcom never intended to use the Houpis test for cost orientation. He put that to you? (After
21 a pause): This should be an easy question.

22 THE PRESIDENT: Yes, he did put it him. We heard it. He put to Dr. Houpis that point.

23 MR. THOMPSON: Secondly, he put it to you that BT never understood that such a test was to be
24 imposed. That is correct, is it not? (After a pause): I think you need to say "yes".

25 A Sorry. Yes.

26 Q And he put it to you that certain details and qualifications, and in particular the escape
27 clauses you envisage for your test, were not made clear at the time and there was some issue
28 of consultation and issues of that kind. Do you remember that?

29 A I think I need to clarify. You are putting some statements to me. So you are saying Ofcom
30 is saying that it never provided the information to BT. My understanding is that Ofcom's
31 position, my recollection from Mr. Saini's questions was that it did not think that it
32 explicitly set out to BT that it would be using a test based on FAC. That is my
33 understanding of the position that has been put to me and if that is a similar wording or the
34 similar position for your second point then I accept that is the case. I am sorry, I am fine. I

1 just wanted to be clear.

2 Q Yes, sure. You will appreciate that it is now seven years since the start of the dispute period
3 in this case and nine years since the period to which the original dispute complaint related.
4 It went right back to 2004, did it not?

5 A I am sorry, I did not catch the seven years. Where does the seven years come from?

6 Q It is now seven years since 2006. I think some of my questions are too easy for you.

7 A We can agree with that but I am not sure what the 2006 refers to.

8 Q 2006 is the start of the dispute period for this decision. 2006/07.

9 A Yes. That is what you say, yes.

10 Q I think in your evidence you said that your test in its present form ----

11 A Sorry, I hope there was some -- I am fine, but you are putting statements to me and I do not
12 want to delay you either.

13 Q I think these questions are very easy for you.

14 A I am just not sure if it is 06/07 or 05/06. I was not sure because it is not my period.

15 Q As I understand it, you said that the Houpis test in its present form was developed only this
16 year, after the decision in this Appeal Court. Do you remember saying that? You disowned
17 the Frontier report and said that the Houpis test was in your witness statement. That is
18 correct, is it not?

19 A No, that is not correct. What I said was that the principle of the test is very similar in the
20 report that Frontier did with the principle of the test in my report. So I do not think there is
21 any difference in the principle. Both tests are aiming to restrict the ability of BT to earn
22 returns that are significantly higher than its cost to capital. So in that sense ----

23 Q Yes, but you will understand ----

24 A Excuse me?

25 Q I am sorry.

26 THE PRESIDENT: Let Dr. Houpis finish.

27 MR. THOMPSON: Yes, I am sorry.

28 THE PRESIDENT: Restrict, yes?

29 A So in that sense I think the tests, the principles are very similar. Now, in terms of how you
30 then decide to implement the test, the proposal that I have made in my expert report differs,
31 is not identical, to the proposal that, as I recollect it, was made in the Frontier report.

32 MR. THOMPSON: Yes, but you understand that this is a case about hundreds of millions of
33 pounds worth of money and so the details actually matter. I think you are saying that the
34 details were only set out in your witness statement this year and, as we would say, they have

1 changed even since then. There was a question from the Tribunal about that yesterday as to
2 how ----

3 A No, I do not agree with that.

4 Q -- exactly the system works.

5 A I think if you actually go and read the Frontier report, it does say that a test should be
6 applied in a non-mechanistic way. I think that was after the provisional Determination. I do
7 not think there is a statement in there which says that Ofcom should go and just calculate
8 FAC and then just apply it directly. I think it would say, I cannot remember the exact words
9 now, I want to go back to the report, but I think it did allow for some flexibility for price
10 above FAC and that is what was said in the Frontier report in I think it was April 2012, and
11 I think my statement also allows for some flexibility. I do not think there is any big change.

12 THE PRESIDENT: I have not seen the Frontier report, but just in very brief outline, what is the
13 refinement or addition or development that you have made in your reports here over the
14 Frontier report?

15 A I think the main difference is that in my expert report I was more explicit about the reasons
16 for which when the test is applied the revenues could exceed FAC, bearing in mind that the
17 difference between the Frontier report and my expert report is that the final Determination
18 was made which did not accept the proposal that was made in the Frontier report. So given
19 that, I think within my expert report I have to be more explicit and more clear about how the
20 FAC test would apply and the main thing was that I was more explicit around that.

21 MR. THOMPSON: Can we just look at one specific example? I do not want to take up time, but
22 if one looks at ST1-3, Tab 14 ----

23 THE PRESIDENT: Dr. Houpis, did I understand, you were not involved at Frontier in preparing
24 that report? Is that right?

25 A I was involved with that report.

26 Q You were?

27 A I was involved with it.

28 MR. THOMPSON: Just in the interests of time, I will just take one example. If one turns to p.29,
29 para.77, the first sentence. You will recall being asked by the President yesterday about
30 when your approach kicked in.

31 A Yes.

32 Q And it says:

33 "For those charges which failed the DSAC test, prices for these services for the
34 second stage check would be imputed at the DSAC level".

1 As we understood it, your approach only kicked in if there were some charges above the
2 DSAC level whereas, I think, yesterday you said it would kick in anyway, even if charges
3 were all below the DSAC level. Do you remember that?

4 A When you say "as we understood it" who are you referring to? Who is the "we"?

5 THE PRESIDENT: I think Mr. Thompson is saying as he understood what you said yesterday,
6 your evidence yesterday.

7 A My expert report and my evidence yesterday was consistent. I think because of the wording
8 in my expert report there was some potential for misunderstanding which Dr. Maldoom
9 raised, I believe, and I clarified that in the joint statement, the second stage test is additional;
10 it's not a substitute for the first test. I think that was my position yesterday and that's the
11 position in my expert report.

12 Q Yes, it is not suggested there is any inconsistency in your evidence yesterday and your
13 report. I think what Mr. Thompson is saying is on the Frontier report, the old report that we
14 are looking at, applying the FAC based test, the second stage only is applied if there is a
15 price above DSAC, whereas you explained that in your report, if the prices are below DSAC
16 you then get a straight FAC test. That is what you say?

17 A Understood. Let me just be very clear about this.

18 Q I think that is the point being put.

19 MR. THOMPSON: Certainly we had understood, not necessarily from this report but generally,
20 that there was an issue that your system only kicked in if at least one price was above
21 DSAC, whereas I think you are now saying that it kicks in anyway so that even if all prices
22 are below DSAC you still apply your approach. Is that right?

23 A Let me try and have another go. In order to implement the test, implement the second stage,
24 you have to make a calculation which is what prices would have been if you had set them so
25 that the revenues were consistent with FAC. To do that, you need to set the prices for all
26 services. Therefore, what I was saying in the Frontier report (and I think you asked me
27 yesterday as well) was that you have to make some assumption about what the prices were
28 if the price was above DSAC in the first stage would be, in order to derive the percentage at
29 which you would then reduce prices to make sure they are compliant with FAC, to generate
30 levels consistent with fully allocated costs. In that sense, that's what I think this says, and
31 that is in my expert report 1. It says you have to reduce – in order to apply the test you have
32 to have a set of prices. In the second stage you have to have a set of prices for all products.
33 So for those products where the compliance at the individual level were found not to be
34 compliant at the individual level, you reduce prices to DSAC. For the other products you

1 use the actual revenues. That's what this is saying. In terms of your point, as I said earlier
2 and I will just repeat it, I appreciate that the wording in my first expert report – because I
3 read that a few times after I read Dr. Maldoom's report – was not totally clear in terms of – I
4 mean, it could be interpreted a different way. I don't think the position has changed; it's a
5 question of precise clarity in terms of how you write the report. I can see that it could be
6 interpreted in a different way and that's why I clarified the position in the joint statement.

7 Q I am now a little bit confused. So what happens if all the prices are below DSAC?

8 A Go to the second stage test.

9 Q You do go to the second stage?

10 A Yes.

11 THE PRESIDENT: That, you say, is what the Frontier report was also explaining?

12 A That is my recollection, I must say. All I was asked to do was to read this paragraph and on
13 the basis of that paragraph I explained my understanding based on recollection of what the
14 paragraph says. If you want me to give you my view more on the Frontier report I would
15 need to remind myself, refresh my memory because it's a year and a half since it was written
16 and I have not read it recently. So I would need to refresh my memory.

17 MR. PICKFORD: Sir, I can deal with this in re-examination. It may assist if the Tribunal turned
18 over the next page on to p.30. (Pause to read)

19 THE PRESIDENT: I am not sure it does, but I think Dr. Houpis did not see that aspect, or did not
20 understand that aspect as being something new in your report, in the previous Frontier
21 report.

22 A That's my position. As I said, to be clear, I have not been able to read the report and I could
23 not be 100% committed to that without being given an opportunity to read my report, the
24 Frontier report, again.

25 MR. THOMPSON: Can we move on. As I understand it, you are now suggesting that your test
26 would certainly be a good way to regulate the UK telecoms market going forward. That
27 was explored with Mr. Saini, and I think you were saying that this would be a good
28 prospective test?

29 A If I may just clarify my position, I'm not making grandiose statements about how the
30 telecoms market should be regulated going forward. I think I was making a more modest
31 one, if I may, which is the decision on this case I think will set a precedent about how, in
32 similar circumstances in the future, a cost orientation could be interpreted. Therefore I think
33 in thinking about the remedy that is proposed in this case, it was appropriate to think about
34 what implications would be for future situations where you would have similar

1 circumstances. In that sense, that is an important part of the thinking.

2 Q I think one of your criticisms of Ofcom is that its own approach was not made clear in 2004.
3 Is that correct? You made various remarks about how, having thought about it, you see it
4 meant this or that. But I think you were saying – what exactly are you trying to do with cost
5 orientation and the basis for it, but that was not clear in 2004.

6 A I think the statement that I've made is that Mr. Myers said there were a number of efficiency
7 considerations and in coming to the view to adopt cost orientation rather than price control
8 all of these considerations were probably, or I think Mr. Myers says he presumes that this
9 exercise was done, and that's how the decision was taken to adopt the cost orientation.
10 That's why I was saying in my mind, if you look at the LLMR statement there is only one
11 sentence which justifies the decision, and there's no real discussion about the allocative
12 efficiencies, etc. In that sense, yes, I think the LLMR statement didn't include the
13 discussion of those issues.

14 Q I understand that. I will come on to the nature of the test in a moment. But sticking with
15 your test, that cannot have been clear in 2004 or 2006 if you were making changes to it this
16 year? That is just obvious, is it not?

17 A No, it's not obvious. I will repeat, I think, the answer I gave yesterday, which is what the
18 expectations are, I would imagine, of a regulated company when it faces a costs orientation
19 obligation as set out in HH3.1 is to make sure that the revenues from services subject to cost
20 orientation to recover long run incremental costs, an appropriate mark up for common costs
21 and an appropriate level of cost of capital. The question therefore is if you are faced with
22 that obligation how does that translate in economic terms in terms of the appropriate cost
23 test? In my view, fully allocated costs is a very sensible, very common and very reasonable
24 measure to use to actually come to a level of revenues which would meet the cost
25 orientation obligation. So therefore, I would expect a company which is regulated on that
26 basis to not be surprised, or not have any reason to be surprised, if when the regulator
27 subsequently is called to resolve a dispute in relation to that, the regulator would adopt a
28 benchmark of fully allocated costs, as I said, in a non-mechanistic way to make sure that all
29 the specific circumstances are taken into account.

30 Q It is not just a sort of general programmatic idea; it is now quite detailed. You have made
31 specific suggestions about the relevant groupings, and specific suggestions about the way in
32 which flexibility should be exercised. I think you said that those were decisions you made
33 yourself this year?

34 A No, I disagree again. Let me just try to set out the chronology as I understand it. Ofcom

1 come up with the provisional determination where it gave a view in relation to what it was
2 planning to do. Then we, Frontier, wrote the report which said that we think it's appropriate
3 to have an additional test, which is based on fully allocated costs. Then Ofcom came with
4 the Final Determination where it did not accept that position. Then I wrote the report in
5 relation to the appeal. I think it is sensible, when I'm writing a report for the appeal where a
6 decision has already been taken by Ofcom not to accept the test, to be clearer in my expert
7 report about how this test would apply. I think that is what you would expect. I don't think
8 there's anything innovative or surprising about this.

9 Q Just bear with me. Supposing your report is the very best report that anyone could possibly
10 write on this subject. If it had been available in 2004 then BT could have thought about this
11 and set its prices by reference to your report. But as it is, your report was not available until
12 earlier this year, was it?

13 A I don't think BT needed my report to comply with the cost orientation obligation. I wish I
14 could claim that. I think BT was subject to a cost orientation obligation which clearly set
15 out how the revenues should relate to costs. In my view, that has the implication that those
16 revenues would be consistent with costs calculated on a fully allocated cost basis. As I said
17 yesterday in my response to Mr. Saini, I think, to a similar question: my understanding is
18 that BT itself has used aggregation in relation to cost orientation services in the context of
19 the PPC dispute. So my understanding is that BT did think, when it was considering pricing
20 of services or groups of services subject to cost orientation, about the returns from those
21 services as a group (that is my interpretation of what I read) and my understanding of what
22 was said was that the group of those services should not be making excessive returns. So
23 my interpretation again of that is that BT was thinking in terms of making sure that
24 revenues would not exceed the cost of capital and FAC is consistent with generating
25 revenues that do not exceed the cost of capital. So I do not see the reason why BT needed
26 my report to come to views about the appropriate way to interpret the cost orientation
27 obligation.

28 Q Just sticking with the groupings issue, for example, you accepted I think that if Ofcom were
29 going to make a decision about groupings it would have to consult and that you had taken a
30 conservative approach because you obviously were not in a position not consult, because
31 you were just writing a report. That is what you said, is it not?

32 A I think what I said is that the decision on grouping depends on the context. So if Ofcom
33 were to apply a cost orientation obligation on the basis of fully allocated costs (as we
34 advocated, as I argued) then at the administrative stage of the proceedings, then Ofcom

1 could have consulted. So if Ofcom, after provisional determination, came to the view that it
2 was appropriate to apply fully allocated costs as proposed, it could have consulted on the
3 grouping.

4 Q Yes, but --

5 THE PRESIDENT: I think the point being put to you, Dr. Houpis, is this. The proper application
6 of the condition is BT is faced with this condition and has to set its prices. It is nothing to
7 do with an Ofcom Determination; it is faced with this condition and it has prospectively to
8 set its prices. If it is applying, as you say it should have done, FAC (and this is BT, not
9 Ofcom) then it has to apply that test and one of the questions that therefore arises is: what
10 services do you group? You discuss that in your first report. Different results will follow
11 according to what you put in the group. It will produce different figures, will it not?

12 A The grouping of the services could affect how revenues would compare to the fully
13 allocated costs of the services. But my suggestion was that it's the grouping of services to
14 which the cost orientation applies in the first instance, and my proposal in the report I think
15 is consistent with -- it broadens, there might be some services where there is a bit of a
16 difference between what is the proposal in the grouping and --

17 Q That is your proposal in your report, but if one took a different grouping the numbers could
18 come out different?

19 A My view is that if one took a different grouping and applied the FAC test, then they might
20 come out a little bit differently. But what you don't get is revenues at DSAC. I accept your
21 point, but exactly how you go about the grouping may affect the exact level at which you set
22 the revenues. I think the main objective is to make sure that there is a constraint in terms of
23 the overall revenues generated for a group of services. The grouping matters (I take that),
24 but I can't see why that could be reason to say therefore we should price at DSAC. I'm not
25 suggesting you put that to me.

26 Q I haven't talked about DSAC. If BT at the time was seeking to set its prices such that it
27 stayed within the condition, which is what it should do, it would not know what grouping
28 Ofcom would consider appropriate, because this has not been set out at the time. You have
29 come up with a proposal which may be the most reasonable proposal, but there are various
30 groupings one could apply. You have discussed them in your first report. The point that is
31 being put to you is that BT in 2004 and indeed 2006 would not know which grouping would
32 be finally decided upon by Ofcom. So it would not know what the actual FAC numbers
33 would be. That is the point, Dr. Houpis?

34 A My position is I'm not quite sure why BT could not do exactly the same thing that I did.

1 The way in which Ofcom would approach the BT grouping is not arbitrary. Ofcom would
2 not just try and pick three services from here, match them with four services from
3 somewhere else and then try and come up with the grouping. The condition applies to
4 specific services. Those services have fixed and common costs between them and they
5 share fixed and common costs with other services. A key driver of the grouping is how
6 those fixed and common costs are shared. The purpose of the grouping, as a reminder, is to
7 allow BT flexibility to flex its individual prices in order to achieve a more efficient recovery
8 of common cost. So I think if BT thought that the grouping that I proposed, provided it
9 would have appropriate flexibility, then it would go to Ofcom and say "This is what we did,
10 and this is our reasoning". I accept Ofcom would have a point of view. I'm not sure why
11 it's necessary in 2004 to have some very clear guidance from Ofcom as to how the grouping
12 is going to happen. It's very clear how these groupings are put together and the rationale for
13 them.

14 MR. THOMPSON: Let me put something else to you, Dr. Houpis. You now think that your
15 system is very good. Supposing there is a yet more brilliant plan which emerges seven
16 years from now. If BT is setting its prices now, should it set it by reference to your plan,
17 which you think is the most brilliant plan that has been devised, or should it anticipate some
18 yet more brilliant plan that either you or somebody else will come up with in 2020? How is
19 BT meant to operate if your plan can come along in 2013 and be the basis on which we
20 assess what BT ought to have done in 2006? How is it supposed to work?

21 A My plan is not - in my view, it's a very similar approach to the approach that Ofcom has
22 with DSAC. I don't think there's anything fundamentally different between my proposal
23 and Ofcom's proposal in relation to DSAC. The difference is the cost standard. The cost
24 standard under Ofcom is DSAC, and the cost standard under my proposal is FAC. Ofcom is
25 proposing a non-mechanistic approach, I am proposing a non-mechanistic approach. Ofcom
26 has taken quite a significant time to hear the views of BT and others as to how the non-
27 mechanistic approach should apply. The same could happen with the fully allocated costs.
28 There were significant exchanges, and there still are, about, for example, the issue of the
29 cost of capital. One of the issues that was raised yesterday by Mr. Saini to me was around
30 dynamic efficiency. BT went, when Ofcom was thinking about the level of BES, WES,
31 DSAC, and argued to Ofcom that it should allow a higher cost of capital for these services
32 because of their nature, as part of the non-mechanistic approach of DSAC. Ofcom looked at
33 the evidence. BT argued for a higher cost of capital and also for other considerations, and
34 Ofcom came to the view that this should not be allowed. There is no difference. That is a

1 dynamic efficiency point. BT said, because of dynamic efficiency we need higher returns.
2 This is the whole evidence that Dr. Maldoom - what Dr. Maldoom's report is based on.
3 Ofcom looked at that and said, "We do not consider in the circumstances that this should
4 apply". Exactly the same thing happens with the application of my test. I don't think that
5 there is anything representing my ... I don't think there's anything particularly new about
6 my test.

7 Q If we just look at the substance of your test. I think the flexibility element, one of them is to
8 look at BT's overall recovery over its entire business. That is quite a challenging thing to
9 do, certainly in a four month dispute period, is it not? That is quite a challenging task.

10 A I think I answered that question yesterday. In the interests of time, do you want me to
11 answer again? I will say the same thing as I said yesterday. I don't mind, but my
12 understanding is that we're ----

13 Q Do you say it is not a challenging ----

14 A Sorry?

15 Q As I understand it, it is quite a challenging thing to do. Do you accept that or not?

16 A I answered the question yesterday, and I said that when Ofcom applies the test it should not
17 include competitive services, it should not include services that are subject to price control
18 generally. There may be some circumstances where that could be allowed, but the
19 assumption is that only cost oriented services should be included. I'm sure that I'm
20 accelerating the speed, because I know I've also been told to talk a bit more slowly. In the
21 interests of time, the set of services from which the choice would be allowed to start with
22 would be the set of services that are subject to cost orientation and cost orientation only.
23 That's not thousands of services.

24 Q Even if you could do it now, can you imagine trying to do it - even imagine trying to do it -
25 in relation to every year for 2004, 2005, 2006, 2007, 2008, 2009, 2010, standing in for
26 2012. How on earth are you supposed to do it, because we are talking ----

27 A Again, I'm a little bit - exactly the same issues were raised in relation to DSAC. All those
28 questions you're posing to me now about FAC, exactly the same issues were raised on
29 DSAC. BT came and said, it was in relation to connections and rentals, but not only that,
30 "We want to re-allocate some costs from one part to another part", and they went to Ofcom
31 as part of the proceedings and said, "We want to re-allocate provisioning costs from this
32 part to the other part". Ofcom had a look at that and said, yes or no, and they did this for the
33 whole period. I don't really see what the difference would be between the way Ofcom went
34 about evaluating DSAC and how it would go about evaluating FAC. They're very similar

1 issues.

2 Q Could you just explain to us what you say would have been clear to BT when it was trying
3 to set its prices in 2004 for 2006? What do you say the test was that Ofcom had actually set
4 out at that time? Was it your test or something else? What was it?

5 A Again, I'm afraid I might repeat myself.

6 THE PRESIDENT: Dr. Houpis, I think you are saying, are you not, that BT had the cost
7 orientation obligation and the condition. As I have understood it, your evidence is that with
8 that obligation it could reasonably have interpreted it as requiring a FAC test that you set
9 out applied in a non-mechanistic way - is that right?

10 A That is right, and I'm actually going further than that. I am saying that BT in other
11 proceedings has said that they did price a set of services effectively on the basis of fully
12 allocated costs. That is my understanding of the evidence Mr. Morden gave in relation to
13 the PPC case.

14 MR. THOMPSON: It was not your test, was it? It was not the Houpis test with all the detail that
15 you have put into it now, was it? It just had some reference to FAC, that is all you are
16 saying?

17 A I'm afraid I'm a little bit - the simple thing my test does is to ensure that prices across
18 Ethernet services are set such that the revenues from those services are consistent with FAC.
19 That is what my test is aiming to achieve. If that happens, then for the group of those
20 services BT would be able to make a return on capital on those services consistent with the
21 regulatory cost of capital that Ofcom has set and Ofcom has determined that it set profit cost
22 of capital. My understanding in relation to the PPC case is that BT said, one of BT's
23 employees said, that BT was setting prices for PPC, for the group of those services, the
24 whole group, so that the returns would not be higher than the cost of capital. That is exactly
25 the same thing as would happen under my test.

26 Q Are you saying that the Tribunal in PPC was completely wrong and that the real test that BT
27 was facing in PPC was your test?

28 A What I'm saying is that BT - a question has been put to me that the test might surprise BT.
29 There is no reason why BT should not be reasonably be expecting to face an application of a
30 test which would require the revenues of services outside of cost orientation at the group
31 level to be consistent with FAC. All I am saying is that my understanding is that within the
32 PPC case, an employee of BT said that prices were set for a group of services that were cost
33 orientated so that the revenues would be consistent with FAC. As a result, I'm not quite
34 sure how BT can say they are surprised by my test.

1 Q Can we look at paras.3.17 and 3.24 of your last report.
2 A Which page, sorry?
3 Q Page 15. You are dealing with a criticism that is a retrospective imposition of price control,
4 and at the end of the paragraph you say that the criticism:
5 "... also fails to recognise that a retrospective use of any cost standard could be
6 argued to have the characteristics of 'rate of return' regulation – this is not in my
7 view therefore a material difference between the two approaches other than in the
8 allowable rate of return that is allowed."
9 Then at 3.24 in the middle you say:
10 "I note that the use of any cost standard retrospectively to assess cost orientation
11 could be argued to have this characteristic ..."
12 so that is rate of return regulation -
13 "... if the cost standard is binding on the regulated company. This is not therefore a
14 distinctive characteristic of the approach proposed in the first Houpis report."
15 I would just like to understand what you mean there by "distinctive". Are you comparing
16 your approach to Ofcom's approach in the Decision?
17 A I'm comparing the two - yes, in the Determination.
18 Q So you are saying your approach is no more uncertain than Ofcom's - is that right?
19 A Uncertain in what sense?
20 THE PRESIDENT: No more retrospective, I think is what Dr. Houpis is saying.
21 MR. THOMPSON: No more retrospective, indeed. The criticism is that that makes it totally
22 uncertain.
23 THE PRESIDENT: Is that right. When you say "This is not a distinctive characteristic of the
24 approach proposed", do you mean it does not distinguish your approach from Ofcom's
25 approach? That is what you mean, is it not?
26 A That is correct, "significantly", if I may just add. There is some difference, but it's not a
27 material difference.
28 MR. THOMPSON: Ofcom's approach is binding because it is the basis for my clients pay your
29 clients tens of millions of pounds, is it not?
30 THE PRESIDENT: I do not follow that question.
31 MR. THOMPSON: He says if the cost standard is binding on the regulation of the company, the
32 Ofcom standard is binding on BT, because it is the basis for this Decision. It is certainly
33 being treated as binding.
34 A I think the question I'm answering here, because I think we're mixing two things - the point

1 I'm making is one of the criteria on which the two approaches, my approach and Ofcom's
2 approach, are being compared is the extent to which they provide incentives to the regulated
3 company to achieve cost efficiencies. I'm making the simple point that the cost orientation
4 obligation has worse incentives in relation to this than to multi-year price control, and I
5 think that is a common agreement amongst the experts. I am then making the additional
6 point that if you're comparing Ofcom's approach, where the cost standard that is used to
7 assess cost orientation is DSAC, with the Houphis 1 approach, where the cost standard that is
8 used to assess cost orientation is FAC, if those two costs standards are binding for the
9 company when it is actually setting its prices (it's not to do with repayment subsequently),
10 when the company is setting its prices, if those standards are binding, i.e. it is pricing up to
11 the limit, then the two approaches would provide the company with the same incentives in
12 terms of cost minimisation.

13 Q Why do you say "retrospective"?

14 A What do you mean by this?

15 THE PRESIDENT: At 3.24 you are responding to a criticism in this section that it is the
16 retrospective imposition of price control, and you say that the use of any cost standard
17 retrospectively to assess could be argued to have this characteristic if it is binding?

18 A Sure.

19 Q What you are being asked is whether the Ofcom DSAC standard is binding. Are you saying
20 there that that is also, therefore, retrospective?

21 A Let me explain, all I mean by the word "retrospective" in that sense is I am making a
22 distinction of price controls, not in relation to the standards. By "retrospectively" what I
23 mean is that the company, under a cost orientation obligation the test, will assess the
24 revenues that the company made to the costs after the event. When you are setting a price
25 control you are setting prices in a forward looking way so that prices converge to what you
26 project in terms of cost. There is a fundamental difference between those two approaches.
27 So all the "retrospective" meant was that you are assessing prices against cost after the
28 event.

29 MR. THOMPSON: The whole section is headed: "The proposed approach does not amount to a
30 retrospective imposition of price control"?

31 A Yes.

32 Q And the criticism is that you can obviously have a prospective imposition of the price
33 control because that is what happened in 2009, so the whole criticism is that it is
34 retrospective, is it not? That is the whole point.

1 A Maybe you can explain to me the point a bit better, because I'm not sure I'm following.

2 Q Ofcom are saying that your system is tantamount to a retrospective imposition of the price
3 control?

4 A Yes.

5 Q You say any system that is binding retrospectively could be open to the same criticism, and
6 you say it is not distinctive, so you are saying it is not distinctive as against Ofcom's
7 approach?

8 A No, I am not saying that. I think you are mixing two things. There is one thing which
9 relates to the cost minimisation properties of the two tests, that is at 3.24. There is a
10 different point which is whether my proposal, compared to Ofcom's proposal, amounts to a
11 retrospective imposition of a price control. I was asked yesterday by Mr. Saini and I gave
12 the answer to Mr. Saini, and I can repeat the answer if you want me to. Do you want me to?

13 THE PRESIDENT: Perhaps you had better clarify it for Mr. Thompson?

14 A Okay. I said that it is not possible to impose retrospectively a price control because, by its
15 nature, the price control is forward looking. Therefore, to put it in even more simple terms,
16 had BT had the price control in 2004 the whole idea of that is that it should try and
17 incentivise BT to reduce its costs. So the costs we would observe, had BT had the price
18 control in 2004, are not the costs we are observing, or may not be the costs we are
19 observing, and that is all I meant in terms of my first point.

20 The second point is that under my proposal the cost orientation test allows prices up to
21 FAC, revenues up to FAC, but it can also go above FAC if it is appropriate, which would
22 not be possible under a price control.

23 There is a third element which is under the price control, it is the regulator, it is Ofcom
24 which will decide what is the appropriate level for prices ... and under the cost orientation
25 obligation my understanding is that it is for BT to come and explain why, in the first
26 instance, it considers that its revenues were cost oriented and if that fails then Ofcom has to
27 apply the test, and that is also true for my test. There are very significant differences
28 between the ...

29 MR. THOMPSON: I know you are making a specific point about the characteristic of cost
30 control. If I make a broader point, how can it be right for a cost standard set in 2012 or
31 2013 to be imposed as the standard that BT should have followed in 2004 or 2006?

32 THE PRESIDENT: I think Dr. Houppis' point, and he will correct me if I have misunderstood it, is
33 a much simpler one. He is saying that whenever a regulator applies cost orientation to a
34 company in a decision saying: "Your prices should have been at this standard. They were

1 not and therefore you have to pay for the difference by way of an overcharge", that is
2 retrospective, and it is no more retrospective if it is applying an FAC standard than a DSAC
3 standard, and therefore what Ofcom did was also retrospective, the only difference is that
4 you are saying they should have used a different standard, but it is no more or less
5 retrospective. Is that the point?

6 A The only thing, because I wasn't sure, under cost orientation I wasn't sure if it is a price
7 control or cost orientation, but under cost orientation that's right, yes.

8 Q Under cost orientation it applied in this way. I think some of your question earlier was a
9 slightly different point, namely, how could BT have known in 2004 and so on at the time it
10 was pricing, that FAC would be the standard applied. Dr. Houpis answered that, I do not
11 know whether perhaps convincing or not, but his answer was: "On the basis of looking at
12 the terms of the obligation this would be what BT could reasonably expect"?

13 MR. THOMPSON: Yes. I suspect there may be some agreement between Dr. Houpis and myself
14 that Ofcom is in no better position than he is, but obviously there is a question about the
15 implications of that and that could be a matter for Mr. Myers next week. I see the time, I
16 am afraid I have not finished FAC and DSAC and I have not dealt with interest. I could
17 probably finish FAC and DSAC in five minutes.

18 THE PRESIDENT: How much time is needed with Mr. Holt?

19 MR. THOMPSON: I will leave that to Mr. Read.

20 THE PRESIDENT: Have you had a chance to consider between you in the team - you will have
21 to allow some time for re-examination and the Tribunal may have some questions for Dr.
22 Houpis.

23 MR. READ: Exactly, Sir, and between us we think that if one allows, say, half an hour for him to
24 be sworn, and dealt with in chief, and then sometime also within that half an hour for re-
25 examination, we think that we should take possibly a little bit more than two hours, which
26 means that probably we would need most of the afternoon effectively to guarantee that Mr.
27 Holt can be free to go at 5 o'clock this afternoon.

28 THE PRESIDENT: Yes. Dr. Houpis, you have seen what the problem is, and if you need to
29 make inquiries over lunch you are free to make that phone call. Are you able to come back
30 at 10 o'clock tomorrow?

31 A I am, but I would appreciate if we can finish one section. I assume there will be some more
32 cross-examination of me after lunch, or are you proposing that you would go to Mr. Holt?

33 THE PRESIDENT: Just answer the simple question, please?

34 A I can come, yes.

1 THE PRESIDENT: You can come back at 10 tomorrow to continue your evidence, yes, thank
2 you, that is very helpful. So Mr. Thompson, you say you have only got about five minutes
3 on SAC and DSAC. If it is really five minutes you can do it now. If it is going to be more
4 like 10 or 15 then it might be better to do it after lunch.

5 MR. THOMPSON: I would not like to guarantee five minutes given the answers ----

6 THE PRESIDENT: What we will certainly do is conclude that topic and then you say you wanted
7 to ask some questions about interest, is that right.

8 MR. THOMPSON: Yes, it is a large topic and there is no other expert addressing it. I will not be
9 long on that.

10 THE PRESIDENT: The sensible thing to do is to conclude FAC/DSAC, interest is an entirely
11 distinct area, and then to interpose Mr. Holt.

12 MR. THOMPSON: It is just a question of whether you would like to sit slightly late now and
13 finish Dr. Houpis so we could then start clean with Mr. Holt, or whether you would rather
14 break and come back for 15 minutes of Dr. Houpis after lunch?

15 THE PRESIDENT: I am just concerned that 10 minutes becomes 15 minutes, becomes 20
16 minutes.

17 MR. THOMPSON: I do not think it should do, I am essentially ----

18 THE PRESIDENT: Right, well you go on then, we will continue until 1.20 but not longer.

19 MR. THOMPSON: I simply wanted to deal briefly with the issue of efficiencies, and the merits
20 of your approach, but given that Mr. Saini has discussed this with you at some length, I will
21 pick up only three points. The first of the points arises from your fourth statement, para. 2.3
22 and 3.49. I think, given the time we can go straight to 3.49. I do not think the table is
23 marked as confidential but is anyone claiming confidentiality on this figure? You are
24 asserting that there was a total difference between DSAC and FAC of over some £350
25 million between 2007 and 2011. As I understand, you are making the point to illustrate the
26 leeway that BT has given under the current regime, although it is mostly in 2010/11, that is
27 correct, is it not?

28 A I think the objective is, as you set out. In terms of the calculation, there are some constraints
29 in the calculation so the way I have done the calculation here is to look at those services
30 where there was an overcharge finding. This was just for timing purposes so therefore what
31 you see there, if you see the source it's the Ofcom Determination table 13.37 and that covers
32 only those services where there was an overcharge. There are other services where there
33 would be a difference between DSAC and FAC, which would push this number higher, and
34 I think also there are services which are outside, there are other bandwidths which, again, at

1 least for the first period could push the number higher. So what I was trying to do is to give
2 an indication, a sense of magnitude. I wasn't trying to come up with the precise estimate of
3 the potential.

4 Q From your point of view there is that point, on the overall merit between the parties it is an
5 illustration of what a commercial advantage there would be to your test as against any other
6 test in this particular appeal. That is fair, is it not? It shows the scale of the commercial
7 incentive, as it were, to raise this point?

8 A I understand why you are interpreting it like this but I think the point I am trying to make is
9 that under the Ofcom test what we are looking at is the prices that could be set for the group
10 of services up to DSAC. I have explained in my first report why, I have set out the reasons
11 why I think that would be detrimental for consumers and for downstream competition, and
12 what I did in this report is to provide an indication of the potential detriment. That is what
13 this number represents. In my view as an economist this is absolutely critical. You cannot
14 come to a view as to the merits of the test without coming to a view as to, if you adopted
15 the Ofcom test, how material would be the distortion for consumers.

16 Q The second point I wanted to raise was the incentive effect of this approach as against the
17 DSAC approach and that is dealt with at 3.9 of your fourth report.

18 THE PRESIDENT: Just before we leave that ----

19 MR. HARRISON: Given that the table in here is important, and if you go back to the table you
20 have taken it from, which is bundle B, p.328, when you look at this the way in which you
21 have calculated this there is a straight arithmetic difference between DSAC and FAC?

22 A That's correct.

23 Q And although your wording actually covers the point, in the wording it talks about the fact
24 that if, for example, the prices were below DSAC then they would not be relevant to this
25 table, would they, in your interpretation. Although this is just an arithmetical difference
26 between DSAC and FAC the extent to which prices were below DSAC should be deducted
27 from this table in order to show the relative importance of your test versus the approach
28 adopted by Ofcom?

29 A I am not sure that is quite correct. I will just try and answer that question. There are two
30 questions. The first question is, under the Ofcom test BT could price all the way up to
31 DSAC, all its services, and what this table does is under that hypothetical assumption,
32 which is not necessarily what BT did, but under that hypothetical assumption it has come up
33 with a number which, if BT were to do that, what would be the difference in pound terms.
34 That is what this table does. There is a separate then question which is, given BT's prices,

1 given how BT has priced, how much higher were the revenues/the prices for all services
2 compared to what they would have been if it had priced in a way to make sure revenues is
3 equal to fully allocated cost, and effectively that would be the difference between revenues
4 and fully allocated cost over the period, but that is not the calculation I have done within
5 this.

6 Q Okay. Perhaps if I can make it easier, if we look on Table 3.28, you can see that the
7 calculation there that you have taken is between FAC and DSAC, but the external revenues
8 were below DSAC.

9 A Correct.

10 Q So therefore in total you can see at the bottom of the table, in 2009/2010, 57.1, 1.2 and 21.4.
11 The implication of the table, I am not saying that this is precisely what you said, but the
12 implication of the table is that there is a further, if you like, if we placed it at DSAC, there
13 would be a further potential for repayment of up to 352 million.

14 A No, I think you need to be a little bit careful when you say "potential for repayment". What I
15 am trying to give in this is a sense of what would be the better thing for consumers. The
16 dispute covers the period of 2006/07 to 2008/09. The reason I extended it to the extra years
17 is because after 2009 Ofcom did a price control for the services. Okay? So let's take this
18 hypothetical. BT did not price all services at DSAC and I am with you there, okay, but let's
19 say hypothetically it did. Then Ofcom comes in 2009/10 and puts a price control. Okay?
20 Typically the way Ofcom would go about this is to set a glide path. It would not say in
21 2009/10, "I am going to reduce all the price from DSAC to FAC and then keep it constant".
22 It would say, "I am going to put a glide path", and that is what they did. Therefore if prices
23 were set at DSAC during the three year period, that detriment, that difference, would
24 continue after 2009/10, and that is what I was trying to capture with that.

25 Q My point is a much more simple point. The fact is that in 2009/10, taking that point, that
26 actually they did not price at DSAC, so if we apply the numbers in your table as being the
27 FAC then we would actually be resulting in an overpayment to the extent to which external
28 revenues were below DSAC. So in that particular case, that particular year end I am
29 demonstrating this, is 57 million. Now, you are actually ----

30 A I am sorry, I am not sure of the question.

31 Q What I am saying is, that the impression given by this table, as I said before, is that by
32 applying FAC there would be another £353 million potential overpayment. That is the
33 margin that you are trying to demonstrate between DSAC and FAC.

34 A If BT priced all its services at DSAC, which it would be allowed to do under the Ofcom

1 test, and my test applied, that is correct.

2 THE PRESIDENT: You are recognising that in fact they did not, if one looks at 3.15?

3 A Of course, yes.

4 Q So it is not actually. It is a hypothetical potential overcharge, not any estimate of an actual
5 overcharge?

6 A I accept that but my point is that if you actually look at the overcharge over the three year
7 period, which is the calculation that Mr. Robinson has done, because that does not cover all
8 the services where revenues were above FAC, then the number would be again in the
9 hundreds of millions. I cannot think of it off the top of my head, but it would be a number
10 close to 300 million, might be even more than that, so I think the numbers would be similar.

11 MR. THOMPSON: So your suspicion was correct. I do not know if Tribunal has other questions
12 on FAC and DSAC, in which case it is probably sensible to have lunch.

13 THE PRESIDENT: We will not go into those now. It was just while we were on the table, as
14 you were asking about that.

15 MR. THOMPSON: I have two, one which I thought was very short.

16 THE PRESIDENT: Carry on.

17 MR. THOMPSON: I think the second point, which I think can be taken very shortly because it
18 has been a debate between the experts but I think you recognise that it is an issue, which is it
19 is essentially correct that your regime does have less good incentive effects for cost
20 reductions on the part of BT than, in particular, a cost control based on RPI -X, the glide
21 path system that you, I think, just mentioned. In relation to the conventional cost control the
22 benefit, in terms of incentives, is that BT, if it makes cost savings, will take the profits for
23 the period of the cost control whereas under your system next year the FAC will have gone
24 done and it will have to reduce its prices. That is fair, is it not?

25 A I think under both Ofcom's test and my test, both of those tests have less attractive
26 properties in terms of incentivising efficiency compared to multi-year price controls. That
27 is correct.

28 Q I will not get into the difference between DSAC and your system because I think that has
29 been fully debated by the experts. The third point is something you discussed with Mr.
30 Saini this morning, which is the impact on the wholesale market. You seem to accept that
31 this was a priority of Ofcom in the period from 2004 to 2008, although you sounded more
32 doubtful yesterday.

33 A I think I have answered the question. I am not sure if I can add more to this.

34 Q Okay. At 3.27 of your fourth report ----

1 A Of where, sorry?

2 Q 3.27. Your approach is "they should be expected to promote efficient entry". Would it not
3 be more accurate to say that it should be expected to deter entry by anyone who could not
4 match BT's economies of scale because BT would be subject to a very tight regime and
5 make it very difficult for anyone else to enter. Is that not true?

6 A I do not think that is true. I think there are different ways in which potential entrants can
7 complete with BT. One of which is scale, and you are right on that, but there are also other
8 ways in which they could compete to try and reduce or have lower costs. So I think that the
9 implication is that I do not think it necessarily is scale but obviously that is a bigger
10 question.

11 Q Have you seen the evidence of Miss Wray about what Ofcom was saying to BT about its
12 pricing? Did you see that?

13 A No.

14 Q I will take you just to one passage. It is in CBC, Tab 1.

15 A Which paragraph, I am sorry?

16 Q If you look at para.24, for example:
17 "Ofcom, however, may have had wider considerations; for example, CPs that owned
18 their own backhaul network or which were able to provide backhaul circuits to other
19 CPs welcomed the relatively high prices for BT's higher bandwidth circuits and did
20 not want those prices to be reduced by Openreach. This would have made it more
21 difficult for them to compete in terms of price by under-cutting Openreach".
22 So that is unchallenged evidence of Ofcom's concerns at this period and not wanting BT to
23 cut its prices. Do you see that?

24 A I am not in a position to comment as to whether it is challenged or unchallenged. I can see
25 that Miss -- is it Miss Wray or Mr. Wray?

26 Q Miss Wray.

27 A I can see that is what Miss Wray is saying, yes.

28 Q Then there is a quotation at para.39 where Ofcom is saying:
29 "... we would prefer you to stick to your current prices. If you put out a set of prices
30 which undermine unbundled Ethernet access as a commercial proposition, which
31 therefore makes the delivery of EoI on that product irrelevant, then you must
32 understand that that would be a big issue for us".
33 So there is an issue that Ofcom is raising about BT pricing too low and preventing
34 competition. Do you see that?

1 A If you want me to properly - I am not able to comment by reading this particularly, I am
2 afraid. I have not read this statement before. It is the first time I am actually reading it, so if
3 you want me to respond then I will try and read it more carefully. I am not ----

4 Q I think you understand the general point that if BT prices too low then that may deter
5 competitive entry, and that is a fairly straightforward point, and I am simply putting to you
6 that there was evidence, which has not been challenged, to that effect.

7 A I have expressed - I think I have answered that question and I said, yes, that if BT was able
8 to price at a very low level that could deter entry but I do not believe that therefore it should
9 be allowed to price up to DSAC. I think that was the answer I gave, I think, this morning.
10 Mr. Mayer asked this question as well, I think, or a question along those lines.

11 Q Are you aware that some of the CPs, in particular Virgin, objected when BT dropped its
12 prices? Are you aware of that?

13 A What I understand is, I have reviewed the evidence of Mr. Morawetz, I think who works for
14 Virgin, and I know that he was asked again by Professor Mayer, "Do you prefer the lower or
15 higher wholesale prices?" and he said, "Yes", and he raises, I think he meant "wholesale"
16 which implied retail prices as well, to the extent that they do not buy services from BT they
17 would welcome that because that gives them more margin. That is not surprising and I
18 understand that, but I do not think that has any implication in terms of whether prices for
19 those services should be higher than FAC.

20 Q Would you accept that it would be ironic and unfair if CPs were able to press Ofcom to
21 prevent price reductions during a period of cost orientation but could then subsequently
22 claim money back on the basis of breach of that orientation? Do you accept that would be
23 an unfair situation?

24 A Could you ask the question again because I am not sure I am -- What exactly is your
25 question?

26 Q I think you have accepted that there are advantages on the wholesale market for prices being
27 not too tight because that means that CPs can enter that market.

28 A I have not accepted that. I am not sure where you get that from. When did I accept that? I
29 am sorry, but I do not believe I accepted that at any point.

30 Q I am sorry, I may have misunderstood you, but I thought that is what you had accepted, that
31 if BT prices were too low on the upstream market that can restrict entry. I think it was in
32 response to Mr. Saini and it is surely correct as a matter of principle.

33 THE PRESIDENT: Yes. I think he has accepted that but he says it does not mean that they
34 therefore have to price up to DSAC to encourage entry, but if they price at a very low level,

1 it is a question what too low is, but there is a level to which they could reduce their prices
2 which would deter entry.

3 A Yes, I think the question that was put to me was that I accept that higher wholesale prices
4 are conducive to entry and I have never accepted that as a principle. What I said was what
5 the Chair set out.

6 MR. THOMPSON: Dr. Houpis, I think that is probably a good place to break. There are more
7 questions I could ask you but I think, given the time ----

8 THE PRESIDENT: Mr. Thompson, it is an important area, the Sky and TalkTalk appeal. If,
9 having reflected on it, when Dr. Houpis comes back, you have an additional question about
10 FAC/DSAC we will not stop you asking it, but I think we must stop now.

11 MR. THOMPSON: I agree. Can I effectively give an undertaking that I will not be more than an
12 hour tomorrow.

13 THE PRESIDENT: We will look at that at the end of today, but what we will do now is we will
14 break until 2.20 and then start Mr. Holt, and interpose Mr. Holt. Does that cause you
15 problems with Mr. Holt?

16 MS. ROSE: I just wanted to know if that was going to give Mr. Read enough time.

17 THE PRESIDENT: With Mr. Holt this afternoon?

18 MR. READ: Sir, 2.20. I think that we will have to finish him by 5.00 or as close to 5.00 as the
19 Tribunal will allow. We think we may actually be a little less time than we indicated, but I
20 do not obviously want to give any guarantee that we are going to take much less than two
21 hours. We certainly would not want to be in a position where Mr. Holt was not finished
22 today.

23 THE PRESIDENT: Yes. It is only the two of you who are cross-examining?

24 MR. READ: Yes.

25 THE PRESIDENT: Yes, 2.20. Dr. Houpis, that means that you have not concluded your
26 evidence and you cannot discuss the case with anyone at all. I think we can say that there is
27 no need for you to stay this afternoon. If you could be back at 10 o'clock tomorrow
28 morning. So 20 past 2.

29 (Adjourned for a short time)

30 THE PRESIDENT: Yes, Ms Rose.

31 MS ROSE: I call Derek Holt.

32 MR. DEREK HOLT, Sworn

33 Examined by Ms ROSE

34 Q Mr. Holt, could you please take up bundle D tab 12. Do you see there a report with your

1 name on it?

2 A Yes, I do.

3 Q If you turn on to p.40 is that your signature?

4 A It is indeed.

5 Q Do you adopt this as your evidence?

6 A Yes, I do.

7 Q Would you like to wait there.

8 Cross-examined by Ms LEE

9 Q Good afternoon, Mr. Holt. I am going to ask you some questions on behalf of BT about the
10 issues that you discuss in section 3 of your report, and then shortly after that Mr. Read is
11 going to ask you some questions about section 4. Can I begin with something that you say
12 concerning cross-subsidy concerns. I can just tell you what the joint expert statement says
13 at bundle B 1.4 p.24. I do not think we need to turn it up. You say there that depending on
14 how an aggregated approach would be applied there may be cross subsidies between CPs.
15 That is your position, is it not?

16 A Yes.

17 Q The caveat that you put in, depending on how an aggregated approach would be applied, is
18 there because you do accept, do you not, that aggregation can be carried out without any
19 cross subsidy issue arising?

20 A Yes, that's right.

21 Q Again, I do not think we need to turn this up, but when Mr. Harman says, for instance in
22 para.2.20 of his first report (D6 p.19):

23 "Ofcom's methodology [for assessing the extent of non-compliance] can easily be
24 modified to address any concerns relating to cross-subsidisation (to the extent they
25 are actually identified)."

26 You agree with that statement, do you not?

27 A Yes, I do, depending on how the construction would be made, yes.

28 Q May I ask you to look at paras.62 to 65 of your report at tab 5.

29 A Yes.

30 Q You go there through two approaches to aggregation: one on a CP by CP basis; and one on
31 a total CP basis. We see in your tables in para.63 what you have done?

32 A Yes, that's right.

33 Q Then going over the page the last sentence of para.64 you say that under the CP by CP
34 approach it cannot be said that cross subsidies exist between the two CPs "since the test is

1 applied independently for each."

2 A That's right, yes.

3 Q Could I ask you to turn to Mr. Harman's first report bundle D tab 6 p.46 para.3.82. In the
4 first sentence of para.3.82 he makes a point about what Ofcom has done in the Final
5 Determination and goes on in the second sentence to say:

6 "If BT's overcharge was calculated in respect of each CP separately, then clearly
7 no such cross-subsidy could exist."

8 Then he goes on to explain his approach. Then, picking it up a little bit later in 3.83 he
9 says:

10 "Consequently, the approach is neutral to whether CPs buy in fixed proportions to
11 one another."

12 Could I ask just you to look at those paragraphs. Do you agree with all of those comments?

13 A I disagree with the last comment, so I would agree that you can construct an approach that
14 doesn't lead to cross subsidy, but I don't agree that the fact that CPs buy potentially in
15 different proportions would have no implication as to whether you use an aggregated or a
16 disaggregated approach.

17 Q Just to be clear, is that in relation to your point about price signals or distortions?

18 A It's in relation to the set of consequences that I identify in the report, yes.

19 Q That you discuss in your report?

20 A Yes.

21 Q We will come on to those in a moment.

22 A Sure.

23 Q If you then go back to your report, please, at para.57, you see there the first sentence you
24 say:

25 "I agree that depending on how the aggregation would work, the issue of cross-
26 subsidisation may be less of a concern in this case than for charges for trunk and
27 terminating segments, or across bandwidths."

28 That is a reference to the PPC case, is it not?

29 A Yes.

30 Q But in fact it is the case, is it not, that if it is done along the approach 2 lines it is not a
31 concern at all?

32 A Depending on the way in which you would carry it out, yes cross-subsidisation may not be
33 an issue.

34 Q At the end of para.57 you refer to Mr. Harman's preferred approach, which is approach 3?

1 A Yes.

2 Q You are familiar with his three approaches.

3 A Yes, in general.

4 Q You do not mention the report approach 2, do you?

5 A No. It depends on which approach he is putting forward as his preferred approach, as to
6 whether or not there may be a cross-subsidisation effect. So what I'm saying here is that as
7 I understand it, his preferred approach could still lead to cross-subsidisation.

8 Q Can I ask you about that. Sorry to keep dotting back, if you could look back at Mr.
9 Harman's third approach, in bundle D tab 6 p.66 para.5.16:

10 "I note, however, that the appropriateness of Approach 2 depends on whether the
11 DSAC calculations are economically meaningful. If the DSACs cannot be
12 determined then it also follows that the level of cross-subsidy between CPs cannot
13 be determined."

14 Do you agree with the second sentence?

15 A That if the DSACs cannot be determined, then it follows that the level of cross-subsidy?
16 Yes, I guess that would hold. If you cannot determine any DSAC then it would be difficult
17 to assess cross-subsidy.

18 Q So one of the key points Mr. Harman makes about his third approach is actually this, is it
19 not, that as we heard – I assume you were in the Tribunal when he was giving his evidence
20 yesterday?

21 A Yes, I was.

22 Q His position is, is it not, that DSACs are not economically meaningful because you can
23 allocated the connections costs either to connections or to rentals, and therefore the DSACs
24 are not meaningful?

25 A I understand that to be his position, yes.

26 Q You do not comment at all on that point, do you, the uncertainty of the allocation of costs?

27 A No, I didn't focus on that in my report.

28 Q It was not something you focused on at all?

29 A No, it wasn't.

30 Q Mr. Harman's point about approach 3 are – if we turn on to para.5.25 he says that the
31 advantages of his approach 3 are:

32 "the fact that overcharges are calculated based on the total revenue and total
33 DSACs within a service means that the total overcharge is not dependant on cost
34 allocations between charges;"

1 That is one of the advantages. He also sets out a second point, and in the third one which I
2 wanted to ask you about his approach 3:

3 "iii. by allocating overcharges according to each CP's contribution to total revenue,
4 overcharges are adjusted to reflect the mix of connection and revenue charges
5 bought by each CP. Therefore, if CPs bought in varying proportions to one
6 another, the calculation of overcharge will reflect this."

7 A It may well do to some extent, yes.

8 Q Turning back to para.5.23 he makes the point that it is actually quite similar to the approach
9 that Ofcom has used in calculating the overcharge in this case?

10 A I'm not sure whether that holds. I would have to look at exactly how the calculations are
11 carried out, yes.

12 Q So, when you say in your statement and, indeed, in your evidence this afternoon, that there
13 may be cross-subsidy concerns with doing it in an "approach 3" way, if I can paraphrase,
14 that has to be considered in the light of Mr. Harman's two main points, (i) that it is not
15 economically meaningful; and (ii) that you can do the calculation in such a way as to reflect
16 the manner in which the services were bought by the CPs. Would you agree?

17 A I think my point was that actually there could be some cross-subsidy between different CPs
18 under that third approach because the degree of overcharge that would be repaid to one CP
19 may actually be reduced by consequence of some headroom that may have been earned
20 effectively by BT in relation to charges that were below the levels for another CP. So that
21 was my interpretation of what a cross-subsidy would entail in this case. So that was
22 essentially the conclusion I reached.

23 Q But you did not consider, in coming to that conclusion, the two points that I just made to
24 you about Mr. Harman's approach which is firstly that costs are not economically
25 meaningful, and secondly, that you can do something which approximates to the proportions
26 in which people have bought the service?

27 A Yes, it's fair to say that my assessment was essentially basing the definition of price ceiling
28 as per Ofcom's approach, yes.

29 Q Can I turn now to a different subject, and that is in relation to cost orientation you consider,
30 do you not, that cost orientation gives significant discretion on pricing flexibility to the
31 party subject to it. You say that in para. 77 of your statement?

32 A Yes, cost orientation - well, actually the purpose of that is to place a boundary on the degree
33 of pricing flexibility in relation to a charge but that does not mean it removes all flexibility,
34 of course. There is still some flexibility, that is right.

1 Q You are aware, are you not, that Cable & Wireless, Virgin and Verizon do not challenge
2 DSAC as a cost standard in this case?

3 A Right, that's right as I understand it.

4 Q Would you also agree with me that the headroom afforded by DSAC has economic benefits
5 in terms of dynamic efficiency?

6 A Well, I'm not necessarily sure that pricing at DSAC would actually confer the economic
7 benefits. I think a degree of flexibility and pricing can have some beneficial effects along
8 the lines that you identified in terms of identifying a better way, perhaps, to recover
9 common costs. So, yes, a degree of flexibility would be helpful in that regard.

10 Q But certainly in terms of the flexibility that is accorded, say, to Virgin, to invest in its own
11 infrastructure and to seek to build up market share, the higher the charges that BT charges
12 the more flexibility Virgin has in order to achieve that aim?

13 A Right, so is the question that if BT sets a higher wholesale price would Virgin Media in a
14 sense prefer that, benefit from that because if it is constructing its own network there may
15 be more room for entry? Yes, I would agree with that.

16 Q In terms of the issue which faces us in relation to connections and rentals, would you agree
17 with me that there is no reason simply for choosing an approach either aggregated or
18 disaggregated simply because it benefits downstream customers as opposed to benefitting
19 upstream customers? In other words, the balance - it is not simply a reason for preferring
20 disaggregation, but it causes more benefits for downstream customers as opposed to
21 upstream customers?

22 A Obviously what you are trying to do is to maximise overall welfare and to the extent that
23 that includes the welfare of consumers and wholesalers then, I think, yes, you would put
24 some weight on upstream players in that regard. Ultimately, of course, the main benefit of
25 additional competition in the upstream level would be to flow through to enhanced
26 competition in the downstream level. So, overall, you might expect that the real benefit is
27 coming from enhanced competition overall.

28 Q Do you also agree with me in order to show that the aggregation of connections and rentals
29 for cost orientation purposes causes distortions, again for the purpose of the issue in relation
30 to connections and rentals we need to identify any distortions which are said to arise from
31 the £12 million of headroom that Mr. Harman was talking about yesterday? In other words,
32 the difference between disaggregated and aggregated DSACs, or you also termed it a
33 properly constituted DSAC in relation to rentals. So, in other words, not the whole of an
34 overcharge but it is the £12 million?

1 A Sorry, is the question: am I aware that the debate in relation to the effect of the aggregation
2 or disaggregation issue is around that level of overcharge ----

3 Q Yes?

4 A -- rather than the full - yes, I am aware of that.

5 Q And it goes a little further, does it not, because the consequence, in order to look for
6 distortions you are looking for distortions you are looking for distortions that relate to that
7 portion of the overcharge rather than any overcharge above that limit?

8 A Yes, what my report was focusing on is the extent to which the greater price flexibility that
9 the aggregated approach would tend to provide leads to an enhanced risk of the sorts of
10 distortions that I was identifying. Perhaps I can add a comment: I'm not sure that the
11 distortions are necessarily measured by the amount of the overcharge. The amount of the
12 overcharge is, of course, the calculation of the amount of the overpayment over a period of
13 time. My distortions are not specifically identifying that particular calculation. There are a
14 set of potential distortions to economic decisions that companies might be making and
15 actually the counterfactual could be that some circuits were not purchased, in which case
16 obviously that would reduce the extent of the overcharge to some extent, even though there
17 was an inherent distortion in that regard. So if your question is: is the full set of distortions
18 that I have identified equal to the £12 million gap in the aggregated versus disaggregated
19 overcharge calculation then I think the answer to that is clearly "no".

20 Q Did you, when you were looking at your report have clearly in mind this distinction between
21 the amount of distortions that might be caused by the gap, if I just call it the "£12million
22 figure", and any overcharge above that figure, that includes connections and rentals? Did
23 you have that distinction clearly in mind?

24 A No, because as I just tried to explain, the nature of thinking about distortions is not driven
25 by a measure of the overcharge. The nature of the distortions is by thinking of economic
26 effects such as allocative efficiency, productive efficiency and dynamic efficiency issues.
27 Now, I accept that I have not put a particular figures on those distortions, but if I were to I
28 would not necessarily say that that would be the £12m that you are identifying because
29 those distortions could have led to counterfactuals that would have been different from the
30 amount of overcharge that has, in fact, actually occurred.

31 Q And you are referring there to decisions not to purchase effectively?

32 A For example, not to purchase or perhaps more fundamental downstream competition
33 concerns, yes.

34 Q We will come on to that. You say in relation to cost orientation, and this is at para. 85 of

1 your statement, the last sentence I particularly wanted to refer to where you say:

2
3 "... a netting-off process is not appropriate to a cost orientation test which is
4 designed to limit the extent of BT's pricing flexibility for products where it has
5 SMP."

6 But in relation to that does not the issue of whether netting-off is appropriate really almost
7 assume the answer whether or not it is right to have connections aggregated with rentals, or
8 re-allocate connections costs to rentals?

9 A No, I think my point is a slightly different one. What I was trying to draw out here, and just
10 to be clear I was not making any particular comment on the 2009 LLCC price control as a
11 decision that Ofcom made. What I was seeking to do was to distinguish between on the one
12 hand a charge control approach and on the other hand a cost orientation approach and to try
13 and think about whether the economic effects associated with aggregation, which is
14 effectively to permit a netting-off of undercharge by reference to the ceiling in one regard
15 versus an over charge by reference to the ceiling for another charge, which is effectively
16 what aggregation permits you to do. I was trying to consider, okay, if that is really what
17 aggregation is doing, or what a netting-off process would enable is that appropriate in a cost
18 orientation framework as opposed to a charge control framework. Clearly, in a charge
19 control framework, as I state in the report, the primary focus is to control overall rates of
20 return, so you are trying to ensure that monopoly pricing power is controlled by directly
21 setting the level of prices and, indeed, the level of returns to be at or approximately equal to
22 the cost of capital, possibly with a transitional period to get there. In that regard, I do
23 consider that the netting off that an aggregation approach would permit would be relevant
24 because if the company is raising prices on one service the price control basket will
25 automatically require you to reduce prices on another, so that in my view sort of makes
26 sense.

27 From a cost orientation perspective the actual overall objective of that is to place a boundary
28 on the degree of price flexibility for a particular charge. So the notion of netting off in the
29 way that I have just described it in my view would not fulfil that objective, if anything it
30 would loosen the degree of regulatory constraint that you are imposing.

31 Q So this is a point in relation to the way cost orientation works generally, but it is not
32 intended to be a specific point about whether aggregation is appropriate in relation to
33 connections and rentals, is that the gist of what you are ----

34 A You are right that the point was a general one, that is right, but I would suggest that because

1 | it's a general one which holds in general one might apply it in this case as well.

2 | Q Can I look at the question of aggregation, netting off, in relation to the first year of a
3 | purchase by a disputing CP. So in that case the CP buys both a connection and a rental and
4 | considering only the first year, so there is no question of incremental distortion at that time.
5 | Can we suppose that the DSAC for each of connections and rentals is 2 each, so 4 in total?

6 | A Sorry, can you repeat the number? So 2 for connection, two for ----

7 | Q Yes, connection 2, rental 2?

8 | A Yes.

9 | Q But the charges which the CP is asked to pay and pays are a connection of one and a rental
10 | of three?

11 | A Sorry the first set were DSACs, were they?

12 | Q The first set were DSACs and the second were charges?

13 | A Yes.

14 | Q So that in aggregate four has been paid?

15 | A Yes.

16 | Q And the aggregate DSAC is also 4?

17 | A That's right.

18 | Q As I understand your position you are saying that in that circumstance, even in the first year,
19 | one should be repaid because the rental price exceeded the DSAC by one?

20 | A Yes, that's right, and the reason for that is that the DSAC for the rental of two is identified
21 | as the price ceiling, and given that there can be distortions, we will come back on to the
22 | minimum contract period in a moment because I know you made that point, but in general
23 | without putting that constraint on at the moment the DSAC, as an identified price ceiling,
24 | any charge above that can cause distortions in general. I refer in my report to a number of
25 | such distortions which I am happy to comment on if it would be helpful.

26 | Q We will come on to the distortion. So you are saying that, even though the customer
27 | expected to pay for, and did pay for they should receive a repayment of 1, that is your
28 | position?

29 | A I guess my point was a more general one in the context of a DSAC being identified at 2 and
30 | a charge at 3, if this was a committed one year - I think did you say it was a one year
31 | contract?

32 | Q I was just looking at the first year.

33 | A -- and there's no sense in which it might go beyond that, then I think you're right. Then
34 | perhaps there would be a case for assuming that the overall cost of 4 would be reasonable. I

1 think, however, if I could comment on the assumption that you've made, which is let's think
2 about a circuit of one year duration, I think that's actually not the environment in which
3 these purchase decisions are being made. I do recognise that it's a minimum contract
4 period, but that's quite different from a known overall duration of one year. One of my
5 points about risks of distortions was that there's a set of distortions around the rental charge
6 being above DSAC at the point where you're making renewal decisions or continuing to rent
7 circuit, again I'm happy to go through in detail.

8 Q We will come on to that. I am now going to extend it so that you have - I was going to say
9 this: I think that you accept that in that limited example there may be a good case for
10 saying, "Actually, there should be no repayment because you expect to pay for and you did
11 pay for" - I think that is what you have just outlined?

12 A I think what I'm saying is that the degree of distortion would be less if the circuit duration
13 was known and guaranteed to be one year, and there is no uncertainty around that. In other
14 circumstances I think my view would be different because there would be a risk of
15 distortions.

16 Q Just to be clear, the degree of distortion that you refer to, does that, in your mind, justify the
17 repayment of 1? Are you really saying that there should be a repayment of 1 in those
18 circumstances?

19 MS. ROSE: I am sorry, I think they are slightly at cross-purposes. I do not think that he is
20 accepted that there is no distortion in the first year. He has said there would be less
21 distortion if it was a fixed contract and known to be only for a one year duration which I
22 think is a different point.

23 THE PRESIDENT: Is that right?

24 A Yes. Should I expand on why I think that's important?

25 Q Yes, can you explain that?

26 A Okay. If all circuits were being purchased for one year, and one year only, and there is a
27 guaranteed minimum for one year as well, then all CPs would know that they are paying
28 one year's worth of fees. It perhaps would not matter in that particular scenario what the
29 balance of those fees are. You are paying one connection and one rental, and the total cost
30 is whatever it is. The reality of course is that the duration of contracts does vary. I think the
31 factual evidence shows that. I made a reference to it in my report. Also, within CPs the
32 duration of circuits that they have also varies. Furthermore, there is a significant amount of
33 uncertainty as to what the ultimate duration of a circuit might be because it might be
34 renewed or not. I think that was the qualification that I wanted to make.

1 MS. LEE: You are aware also, I assume, of Mr. Harman's evidence about how his particular
2 aggregation works, and he said this again in evidence yesterday that in the first year if you
3 aggregate you get two-thirds?
4 A Yes, I am aware of his calculation.
5 Q And by the third year very, very substantially all of aggregation has taken place?
6 A Yes.
7 Q I will come on to talk about your distortions in a moment, but just going back to my
8 example of the first year, the point is that there is no necessary distinction, is there, between
9 spreading the cost of the connect over just the first year or between years 2 and 3. It is just a
10 slightly different exercise. Unless you can identify particular distortions, and we will come
11 on to discuss those, there is nothing particularly magic about having to do it in the first year.
12 You could aggregate over years 2 and 3, as indeed Mr. Harman has done, and worked out
13 what effect that would have?
14 A Sorry, are you referring to as a method of calculation, is it possible to do an aggregation
15 calculation? I understand that's what Mr. Harman has done, so, yes.
16 Q As I understand it, your only difference in principle is that in a slightly longer contract you
17 consider there would be more scope for distortion or later decisions. Are those your points
18 of distinction in relation to aggregation in year 1 than aggregations in years 2 and 3?
19 A Well, I don't really actually agree with the distinction at all between whether you should
20 aggregate only in year 1 or aggregate in year 2. I think that's a slightly odd way of thinking
21 about how you might do a cost orientation with different approaches to aggregation in
22 different years. I think actually what I'm saying is that there are risks of distortions
23 associated with charges above the price ceiling in respect of either connections or rentals.
24 Several of those distortions clearly materialise after the minimum initial period - for
25 example, where the connection cost has already been sunk and therefore only the rental
26 charge is take into account as a true incremental cost. I think there is that set of distortions,
27 and then there is a further set of distortions which are relevant prior to the end of the
28 minimum initial period, and those could be distortions which arise right up front at the point
29 of the initial decision as to whether or not to purchase the circuit. That's really the main
30 reason why I don't agree with this particular point of Mr. Harman's that you can distinguish
31 between the year 1 aggregation issue and the year 2 and 3, because the notion of a rental
32 charge being above the price ceiling can have implications before year 1, not just after the
33 end of the minimum initial contract.
34 Q Is the principle not the same, if you buy a circuit expecting to keep it for three years and you

1 engage in whole life costing, then why not aggregate the connections and rental charges
2 over the three years and compare those to an agree DSAC?

3 A Again because there are a number of potential distortions which could arise by virtue of the
4 fact that there will be different decisions being made by parties at different points in time.
5 One of those decisions will be the initial purchase and effectively the structure of the
6 connections and the rentals charge could have material impacts on that decision. For
7 instance, if you were to have a CP with a very long duration expectation of a circuit, let's
8 say five years or something like that, then a rental charge above DSAC could have a
9 material impact on their decision as to whether or not they would actually purchase it in the
10 first place, not just the later decisions as to whether they continue to rent.

11 Q But Mr. Harman is talking about a rental charge above a properly constituted DSAC being
12 an overcharge ---- I will start again, if the rental charge DSAC is a properly constituted
13 DSAC - in other words, it either has some of the headroom in connections put on to rentals,
14 or there is no meaningful reason to allocate costs either to one or to the other, then what the
15 customer is paying is a cost which relates to those aggregate costs, is it not? There is no
16 distortion because he is paying a charge which reflects those costs of production in
17 aggregate. What is wrong with that?

18 A Okay, I think there's a separate issue around what is the basis on which the price ceiling is
19 estimated, which I think is the point that Mr. Harman was raising in relation to the cost
20 allocation issue. Would you like me to address that because I think that a separate point to
21 the one I was making about what is the differential impact of the charges as between rentals
22 and connections, which I think it's clear that each of those can have material impacts on the
23 decisions that CPs would make.

24 Q Can we have the decisions - sorry, I did not mean to interrupt. Your concern is that there
25 are distortions when the decisions are taken?

26 A Yes.

27 Q But when you take an initial decision to purchase, we have heard the evidence that the
28 customer expects to pay a connection and a number of rentals ----

29 A Yes.

30 Q -- on that basis having undertaken a reasonably sophisticated modelling exercise in many
31 cases?

32 A Sorry, are you asking me to comment on that?

33 Q First of all, do you agree? That is the evidence.

34 A I do agree that CPs would be obviously trying to take into account as much information as is

1 possible. If that is at the point of deciding on whether to take on a circuit that would
2 include, amongst other things, the rental charges that they might expect to pay, any
3 connection charges that they might have to pay upfront. They'd also be thinking about the
4 demand situation for their own clients, and so forth. So, yes, I do agree that they would take
5 into account both of these costs in expectational terms when they're making the decision.
6 The reason I don't agree that that suggests that you can just move to an aggregation
7 approach is that there's quite a lot of uncertainty about the duration of the contract, and also
8 a lot of variation, both within the firm, as I mentioned earlier, and also across firms. For
9 that reason, the potential effects of a given charge, such as rentals, or it could be
10 connections, could have a material impact on their decision. As I mentioned, in a situation
11 where you have a long expected duration, yes, you will try and take account of all of those
12 rentals, but that would lead to a different decision as to a situation where you have a short
13 expected duration. So there is clearly an economic impact that the balance between the
14 connection and the rental is creating even in that world where the company has a very good
15 understanding of what the duration of its contract is. The reality may be that the duration of
16 the contract may actually depend to some extent on what happens in the future. It's always
17 uncertain.

18 Q In relation to what happens into the future, you do not, do you, take a fresh decision having
19 done your modelling, unless something external changes to affect the factors that you took
20 into account in relation to your decision - would you agree?

21 A Sorry, could you repeat the question?

22 Q You have taken an initial decision based on whole life costing. You do not take a fresh
23 decision, do you, unless something changes about the expectations that you originally had?

24 A That's right, you would obviously take a decision at that time on the basis of your best
25 expectations. Later on a rental could have an important impact on whether you decide to
26 renew the circuit, or not.

27 Q The rental would have an important impact if it went up, would it not?

28 A The size of the rental could actually affect your decision on whether or not to continue with
29 the rental, because there may be changes in the level of demand for the circuit, or the
30 present power that you have in the downstream market. That could lead you to say,
31 "Actually, I thought it might be profitable to have this circuit for five years, but because the
32 rental charge is so high and my pricing power in the downstream market may have changed,
33 now it may not be feasible", whereas if that rental charge was more in line with the price
34 ceiling, for instance, then perhaps he would have continued to efficiently offer that circuit

1 for another year.

2 Q You agreed, do you not, that BT has flexibility either to charge up to the DSAC in relation
3 to connections or to allocate some of its costs to rentals and charge in that way? You agree
4 that, do you not?

5 A I'm sorry, I'm not quite sure I follow the question. Is the question around does BT have
6 flexibility to allocate costs upfront?

7 Q Yes.

8 A Yes, okay. The extent to which you can do that will depend on a number of factors. One
9 factor would be the extent of the common costs between the charges in question, so if those
10 are higher then there would, in general, be somewhat more flexibility. Obviously that
11 flexibility will be bounded by a number of factors, one being the set of systems and
12 approaches that it has put in place in order to carry out the attribution approach. I haven't
13 looked at the detail of how BT carries that activity out, but I do understand that they have a
14 fairly significant amount of resource going into doing just that activity, and that they
15 furthermore have identified a whole range of approaches, attribution techniques, that they
16 see as best practice, and they update as necessary over time. So the extent of flexibility that
17 they have to simply allocate costs to one charge or another is bounded by the need to be
18 consistent and to be able to demonstrate that they have a rational approach that obviously
19 could be subject to challenge.

20 Q If it has that flexibility and could do it in a different way, it is very difficult, is it not, to see
21 that there may be economic distortions from aggregation?

22 A I think my point is that actually there may well be limits to the degree of flexibility, but let's
23 sort of park that point. Are you suggesting that perhaps there is 100% flexibility to allocate
24 all costs to wherever they want?

25 Q Mr. Harman's evidence is that it is completely uncertain as to where the costs -- it is not
26 meaningful to allocate the costs to either one or the other, because this is a service that is
27 bought over time and each of those costs that are referred to can be spread into what he
28 called the recurring cost as opposed to the upfront cost.

29 A Okay. I think if the degree of flexibility is 100%, in other words all costs could be put
30 either into connections or rentals, and I think my understanding of that point of evidence
31 was not that all costs could be put into either camp, it was that BT had made a change that
32 was significant in relation to, I think it was electronics costs, that had been moved from one
33 type of charge to another in the cost allocation process. I do not think it was his evidence,
34 although I am more than happy to be corrected on this, that all of the costs of the other

1 element, i.e. the rentals for instance, could equally be charged back over to the connections
2 amount. Do you see the distinction I am drawing here between, on the one hand, well, some
3 costs were previously allocated to Item A but maybe could be in B, and in the other
4 situation the ones that are already in B may well be very reasonably already in B and should
5 stay there perhaps.

6 Q Yes, but here we are faced with a situation where the excess prices that are being
7 complained of relate solely to rentals, and so the issue that we are looking at is whether
8 connections headroom can be allocated in one way or another to the rentals. So the question
9 is whether the fact that a very substantial amount of the costs, and I think it is above 90%,
10 could be allocated to rentals affects the approach. My question is, surely it must because if
11 you can do it under your pricing flexibility how can there possibly be economic distortions?

12 A On that, I think it is obviously very difficult sometimes to identify what is the right basis for
13 allocation and, as I mentioned, I have not in my report examined that in any detail. I think
14 the only comment I can really offer on that is, firstly, that there is a need to identify some
15 way of doing that, and I understand that BT's evidence is that actually they do have a very
16 extensive system in order to carry out those aggregations. I think my second concern is
17 that, having done that and having actually developed a DSAC for those charges, to then, in
18 the context of a price orientation dispute, go back and claim that we perhaps could have
19 allocated it in a different way, raises some concerns around the ability of the CPs and,
20 indeed, Ofcom to actually monitor the cost orientation, because my understanding is they
21 rely on the RFS to do that.

22 Q I will come onto that ----

23 THE PRESIDENT: That is from Section 4 really.

24 A Well, that does relate to the Section 4, which is about changes to the RFS exactly, and to the
25 extent that you would perhaps -- actually that is a good point. If you sort of think about this
26 part of BT's complaint as being, "Well, actually we could have allocated costs in a different
27 way and that would have led to a different overcharge calculation", that is actually in many
28 respects quite similar to the point about changes to the RFS coming out *ex post* after the cost
29 orientation dispute has arisen. So I think you are right, the sets of regulatory concerns that I
30 identified in Ground 4, which obviously were in the context of specific changes to the RFS,
31 could equally I think be applied in this larger case.

32 MS. LEE: I have one question on that which I will come to at the very end, because it does
33 overlap with Mr. Read's topic.

34 A Yes.

1 Q I think you agree with me that you are less likely to take -- I do not know. Do you agree
2 that you are less likely to take a fresh decision after the initial purchasing decision if rental
3 prices fall rather than rise over the period?

4 A Sorry, if I am a CP?

5 Q Yes.

6 A Have I already purchased the circuit?

7 Q You have already purchased. You have done a modelling exercise. You expect to purchase
8 for, say, five years, three years or five years.

9 A Yes.

10 Q Unless the rental charges rise, you are not going to want to re-visit your initial decision?

11 A No. What would happen, so if the original decision is based on one set of prices and then
12 over time the prices change, then I will obviously update my views on whether or not I will
13 purchase the circuit. Obviously if the rental would come down, I think is your suggestion --
14 --

15 Q Yes.

16 A -- then that would lead me to want to continue to renew it more likely compared obviously
17 to a higher rental charge that might have preceded.

18 Q Did you, for the purposes of your report, look at what actually happened in relation to rental
19 prices over this period?

20 A No, I did not really look at the pattern of prices over time. It was more around the notion of
21 what the impact from moving from an aggregated approach to a disaggregated approach
22 would be for this set of economic decisions.

23 Q So your approach is a theoretical level, is that right? You did not actually look at this
24 particular market and see what happened in relation to prices?

25 A No, I did not try and sort of quantify the effect that I was looking at. I was raising pretty
26 standard economic modelling sort of approaches in terms of thinking about how allocative,
27 productive and dynamic efficiency issues that could arise. As I say, that was perhaps more
28 of less at a conceptual level. What I did seek to do was to understand the extent to which
29 those types of distortions may have been identified on a factual basis and in my report I
30 make a few references, perhaps not for every distortion but at least for some of them, where
31 the CPs say, or the factual evidence in the witness statements, are consistent with the broad
32 economic distortions I have identified.

33 Q But they do not say that the financial circumstances changed in the sense that rentals went
34 up at all, do they?

1 A No, I do not believe that to be the case but I have not re-examined those statements to assess
2 whether that is what they say or not actually.

3 Q It would be quite a relevant point, would it not, in terms of determining whether the
4 distortions that you rely on in your report are present in this case, to have looked at whether
5 or not the prices fell over the period?

6 A I think actually what I was doing was identifying what the type of distortions could be if
7 you did not independently look at cost orientation for both connections and rentals, so there
8 were a range of potential types of behaviour that could materialise. Identifying some of
9 those types of behaviour could actually be quite difficult because some of them are fairly
10 strategic behaviours that BT could itself adopt as a virtue of its vertically integrated nature
11 and those would not necessarily be easy to unpick. So I accept that maybe I have not
12 identified specific examples in each of those cases of the detriments that I have identified
13 conceptually but there are, I think, some examples of that, one of those being the incentive
14 that BT would have to use its knowledge as the vertically integrated operator to identify
15 what are the upcoming upgrades or different sort of services that might be available, and to
16 target the charging structure such that its internal retail business would be able to capture in
17 preference to other CPs any initial upgrade discounts. That is just an example of one of the
18 distortions.

19 Q That is rather a separate point. Can I come on to ask you some questions about that later,
20 because at the moment I was just referring to the fact that it is important, is it not, to see
21 whether or not distortions are likely to occur in practice?

22 A I think, yes, if there is evidence in practice then that would be helpful to understand. Sure.

23 Q Particularly if that has been used to justify a disaggregated approach, one needs to know
24 whether or not these distortions are ever likely to occur?

25 A Yes, if there was evidence that suggested that all of my types of distortions that I have
26 identified could not actually occur in practice then you might put somewhat less weight on
27 them, sure.

28 Q But you have not tried to ----

29 A You might actually still be somewhat worried that even if they have not happened in the
30 past they could still happen in the future.

31 Q The particular instance that I was talking about was a decrease in rental prices. This is a
32 regulated market and the product started off new and is developing over time. Surely the
33 overwhelming likelihood is that charges are going to fall in the future?

34 A In the future?

1 Q Over the period and in the future.

2 A You might expect charges would fall due to factors such as take-up volume, so there might
3 be sort of scale benefits perhaps, so that might be one reason why the charges fell, yes.

4 Q But my general point, I have probably put but I will put it just one more time, is that in fact
5 unless something changed in terms of the service becoming more expensive than you
6 originally anticipated, you are not going to divert from your original decision - you are
7 going to stick with it.

8 A Okay, so back to the situation where you purchase a circuit, you are using it and, if the
9 rental model has fallen, will that cause you to change your decision. Well, okay, I think I
10 understand now where you are coming from. Can there be a distortion in relation to, for
11 instance, a renewal if the price at that point in time is somewhat lower than you had
12 originally anticipated? That is a good question and I now understand it.

13 Q Can I just stop you in relation to "renewal". What are you talking about in relation to
14 renewal? It is not just the end of BT's minimum term. It rolls on.

15 A Yes, sorry, it is at each year where there is an incremental cost that would have to be paid
16 for that rental.

17 Q But my point is that you do not take a fresh decision at the end of each year because nothing
18 has changed. You carry on with the purchase from BT unless and until something has
19 changed from your original expectations. One possibility is that prices might go up but
20 otherwise, if they do not, then why would you take a new decision?

21 A As I mentioned before, the rental and connection might be two of the relevant
22 considerations but also the demand side would be a relevant consideration. So there might
23 be changes in the demand side which might lead you to change your view as to whether it is
24 profitable or not to continue with the rental. So my point was not about the direction of
25 change of rental compared to the original decision. It was about the level of the rental by
26 reference to the price ceiling. So if that were to be higher than the price ceiling, which
27 would be possible of course under an aggregated approach, then you could reach a decision
28 whereby you decide not to continue with the circuit rental even though it would have been
29 efficient to do so had the price been at the ceiling. So there is an incremental distortion in
30 that regard I think.

31 Q Two points in relation to that. The first is that the change in volumes is something external
32 or different from your original projection. That is right? So my point is that unless
33 something changes you are not going to make a new decision and, I think, changes in
34 volumes are something that, in your positive example, are something that were not properly

1 anticipated in the original decision and therefore that is what has caused a new decision to
2 be taken?

3 A I think that is right, that obviously it would be the set of demand and supply conditions that
4 you are taking into account. Those will evolve over time and you will update your
5 expectations of those and you will take the best information you have at any point in time
6 and then compare that to the profitability, or assess the profitability of continuing to rent the
7 circuit on that new information.

8 Q The second point that I want to put to you is that if you are simply talking about the
9 aggregated costs of production, so you are looking at connections and rentals aggregated
10 and you are looking at the 12 million rather than the excess of that, you are not being asked
11 to pay an excessive price, are you? You are being asked to pay the price that is involved in
12 producing the circuit and making it available to rent?

13 A I am afraid I disagree with you on that because the distortion I am identifying is specifically
14 around the rental versus the rental cost, and furthermore I disagree in relation to the
15 aggregation approach because different CPs with different circuit lines will be affected very
16 differently by the balance of connection charges and rental charges being different.

17 Q I did not understand the first point. The difference between the rental charge and the rental -
18 ---

19 A Ceiling.

20 Q -- ceiling?

21 A Yes.

22 Q That is the individual ceiling that you are talking about rather than the ----

23 A Yes. That is right, yes.

24 Q But surely if you can work out what the total costs of production are, is there anything
25 wrong with the CP being required to pay those total costs on an aggregated basis?

26 A I'm not suggesting that CPs should not be paying for the costs of the service. Indeed, that's
27 not what price orientation is about; it's not about an issue about costs recovery. In fact, if
28 you were to charge only up to the DSAC you would over-recover costs on average. So I
29 don't really see the relevance of this point about are you covering the costs or not, because if
30 you charge everything at DSAC, if anything you would over-recover.

31 Q But the point is why not aggregate the DSACs because you are therefore reflecting the total
32 costs of production, are you not?

33 A Again, you would be actually over-recovering for that particular service if you charge
34 everything up to DSAC, by the nature of what a DSAC means; it means that you're

1 effectively allowing for recovery of common costs that are beyond that particular set of
2 products within each of these charges. So I think the problem here is that we're
3 distinguishing between the purpose of cost orientation (which is a limit to pricing
4 flexibility) with cost recovery (which is an issue about a charge control).

5 Q Sorry, to be clear, you do not think you can charge up to DSAC for connection and up to
6 DSAC for rental?

7 A No, I'm not saying that you can't do that; I'm saying that requiring you to be able to do that
8 would not be required in order to enable costs recovery, because the DSAC by its nature is
9 above a general FAC.

10 Q So you are talking about incremental costs in each case. In costs recovery you are talking
11 about incremental costs?

12 A I don't think I'm talking about incremental costs.

13 THE PRESIDENT: You are talking about all costs, are you not?

14 A Yes, all costs. So BT has a whole set of costs. If you charge everything at DSAC you
15 would over-recover.

16 Q But I do not think you are wanting to ask about costs recovery, are you?

17 MS LEE: My point was about aggregation, sir, and whether or not --

18 THE PRESIDENT: Whether or not what?

19 MS LEE: Whether or not if one aggregates -- if one is able to charge up to DSAC for each
20 individually, then how can a distortion possibly arise when one charges up to DSAC on the
21 aggregated basis is the point that I was trying to put across.

22 A Because the whole point of aggregation is that you can charge above DSAC for one of
23 them, and my contention is that that can have distortions in its own right of the nature that I
24 explained before.

25 Q My point is that if the headroom is such that you can do it on both individual charges, then
26 surely you must be able to do it at an aggregated basis?

27 A Well, I think that's where we differ because my point is that each of those individual charges
28 can affect economic decisions, including (as I mentioned) the decision whether or not to
29 cease or continue the rental, but also depending on the different durations of the potential
30 circuits that you're anticipating, it can affect your decision to make or buy.

31 Q Can I ask you a different point, about the point that you made that the life of the circuit is
32 uncertain. You talk about this at para.53 of your statement.

33 A OK.

34 Q Yes. Again, in relation to this, the CP in question will have had a pretty sophisticated good

1 stab at working out what its duration will tend to be. Is that not right?

2 A Yes, it will obviously try to anticipate what the duration will be, depending on the nature of
3 its customer base, yes that's right.

4 Q The fact that you refer to the 90 day notice and the potential increase is a theoretical point
5 and if there are no increases then that is not something that you can learn in this context?

6 A I guess my point here is does the suggestion that a CP will try to take into account the best
7 information it has at any one point in time lead you to suggest that aggregation is the right
8 approach? I think what I'm doing here is identifying a number of reasons why I don't think
9 that's the right approach, because there are limitations firstly to the ability of CPs to whole
10 life cost. They will obviously do that to the greatest extent possible, but they can't
11 necessarily anticipate at time zero what the ultimate out turn price as well as demand
12 conditions will be. That will limit the extent to which they can, with certainty, do whole life
13 costing. Therefore, the other sets of distortions that I've identified would continue to apply.

14 Q But when you come to make a subsequent decision you compare at that stage, do you not,
15 the costs of the new decision? Obviously, if there is a connection and a rental associated
16 with a new cost, then you are comparing your rental charge with the new whole life cost of
17 the new option?

18 A Yes, so at the point that you're part way through a circuit, let's say with BT, your set of
19 options would be: continue to drive the service to your customer and continue to rent with
20 BT; it would be to basically cease paying the rental and then to set up a new circuit, either
21 an own-provide or maybe go to a third party. In those two cases I would agree you would
22 have to take into account whatever the incremental costs of those connections are. If they
23 happen to have a charging structure that is consistent with what BT currently has, then yes,
24 you may end up paying both a connection and a rental charge to those third parties. In
25 relation to setting up your own circuit, obviously you wouldn't be paying anyone anything
26 other than suppliers, to help you do it. So actually it would be an issue around what's the
27 cost structure associated with your own provision? I don't actually know what that cost
28 structure would look like offhand, but that's indeed what you would have to take into
29 account. Then finally, the third option that you would have, of course, is that if it's not
30 profitable you stop, you cancel the contract, you don't do anything.

31 Q Leaving that one for the moment, in relation to the option of changing to a new solution, the
32 rental charge itself is not going to be distorted there if the switch costs are more for the new
33 option. So if build is more expensive, or changing to a new supplier with connection and
34 rental is more expensive, there is going to be no distortion in the decision.

1 A I think at the margin there could be a distortion to the extent that you end up with a less
2 efficient outcome, so if the example that you're describing is that in every other respect the
3 circuit is exactly the same, and you are paying both a rental and connection, then yes you
4 are right, to switch from an ongoing rental to a connection plus rental for another party, the
5 average cost of doing that would have to be higher for the rental paid to BT versus the
6 average cost for the duration of your expectation for that circuit, for the new circuit. That is
7 true. If the rental is above the price ceiling and your expectation is that there's a long-term
8 remaining relationship with your customer, then I think that's actually quite plausible that
9 that could happen, because if the rental is above the price ceiling and someone else is
10 charging a connection charge but a rental charge that is relatively modest, let us say, then
11 because you are looking at a very long expected duration at that point, that can lead you to
12 shift from the BT circuit to a different circuit, and that actually could be inefficient in terms
13 of incremental costs.

14 Q But again it depends, does it not, on whether or not your rental ceiling that you are talking
15 about is a properly constituted one or not? In other words, whether it properly reflects the
16 costs of producing the circuit? It goes back to the whole question of aggregation.

17 A I am actually here comparing the rental price being higher than a ceiling, yes, and the
18 impact of that relative to a potential new circuit that might have a different combination of
19 connections and rentals.

20 THE PRESIDENT: On that hypothesis it does not matter what the allocation is; you are just
21 interested in how much you have to pay?

22 A That's right. At that point you're just thinking about prices. If I'm a CP I'm thinking about
23 the prices that I could be paying, that's right.

24 MS LEE: But you are comparing it to a new option which may well be more expensive?

25 A If it were more expensive, then obviously yes, you would be less likely to go to that
26 alternative option. That would suggest that the distortion wouldn't be as great, or wouldn't
27 happen in that particular event. What I'm saying is that if the rental price is high and that is
28 sufficient (because you have a long expected duration) to lead to an overall costs base that is
29 going to be high in expected terms, compared to an alternative circuit where, even if you
30 have to pay a connection, if the rental is lower, i.e. more in line with some version of cost,
31 then it might be worthwhile making that switch. What I'm saying is that that could be
32 inefficient because the forward looking costs associated with continuing the BT circuit may
33 well have been actually lower than the forward looking costs of setting up the alternative.

34 Q May have been lower?

1 A They may have been lower in costs terms, even though you've taken a decision to move
2 away from the BT circuit because of the pricing.

3 Q But the new circuit you are comparing it with also has the connection and the rental, so
4 you're comparing, in a sense, the decision that you made originally which had a connection
5 and a rental with a new arrangement which involves both a connection and a rental as well?

6 A It may do. I'm not necessarily presupposing what the charging structure for the alternative
7 circuit might be, but that is one possibility. But at the point where the CP is making that
8 decision, it's just the BT rental charge that is relevant from the BT perspective, and it's
9 whatever the incremental costs are that will be charged by the alternative supplier that
10 would be relevant in that regard.

11 Q I think we agree that if the incremental costs are higher for the new alternative, then the
12 rental price will not distort?

13 A Yes, absolutely. If the incremental costs are higher then there would be no cause for
14 particular alarm because the CP probably wouldn't switch in that case.

15 Q In relation to the cease decision, again because some things change – volumes or whatever it
16 is – to invalidate your original decision, that you would make a decision to cease, it does not
17 follow that the rentals themselves, the price you are charged for the rentals themselves, is
18 distorted in any way?

19 A I'm not sure I agree with that because what I'm saying is that the price of the rentals being
20 above the price ceiling – the example is that if the price for rentals had been at the price
21 ceiling rather than above it, and the reason it's above it is because of aggregation, then that
22 could lead to the switch to a less efficient circuit, a higher set of forward looking costs. So
23 if the increment in the rental charge is essentially the additional price that you're going to be
24 paying of course for, let's say five more years as an illustration, then just to put some
25 concrete numbers on it perhaps because we have been talking about this example for a while
26 – let's say the DSAC for the rental is 10 but the charge for rental is 12 and you expect to
27 have another five years' worth of contract left with your customer, so at that point in time
28 you're going to be paying (as you currently expect) the rental charge based on 12, so that's a
29 total of 60. You might think: actually, I might switch to some other guy who, over five
30 years, is going to charge me 58 rather than 60, whatever the balance of connections and
31 rentals is going to be, it's worth making that shift. My point is that that could be an
32 inefficient choice because the actual incremental costs associated with that new circuit
33 might be, say, 55. So they're charging you 58, they're incurring forward looking costs of 55,
34 and you decide to go with it because the charge of 58 is less than the 60 that BT would

1 anticipate charging you. My point is that that's an inefficient decision because the forward
2 looking costs on the BT circuit are essentially – in fact, DSAC is an overstatement of the
3 forward looking cost, that the LRIC would be probably below that, so the forward looking
4 costs may be anything from, say, 10 to 20 for example. In the situation of the new third
5 party circuit, I've just used as an illustration that the forward looking costs are 55 because
6 they have to set the whole thing up. That's an incremental cost of 20 for BT versus 55 for
7 the new third party circuit. That's a waste of economic resources of 35, all in order to avoid
8 the high rental charge.

9 Q But does it not depend on what you are talking about in terms of the high rental charge?
10 Coming back to Mr. Harman's point, if you are talking about the £12 million difference, you
11 are probably not looking at such a large gap, are you, between the rental price and what
12 you're referring to as the individual rental ceiling?

13 A I think rather than talking about the £12 million, I think it is the size of the gap between the
14 rental and the DSAC for the rental which is really the relevant illustration that I was seeking
15 to draw and that was, in my example, quite modest. I was only talking about 60 versus I
16 think 50 or whatever. But, yes, I appreciate that I have just made these numbers up as an
17 illustration. I have not sort of suggested that those are necessarily factually based, but the
18 purpose of this was to show that the high rental charge can lead to a change in an economic
19 decision which can lead to reduced efficiency. That is really all I was saying.

20 Q But it is important to work out how much the extent of that proper high rental charge is and
21 what the reason for it is. In other words, if it reflects headroom that you are entitled to
22 charge in relation to the connection or an allocation of connection costs that you are allowed
23 to put onto rentals, then the decision is not distorted, is it?

24 A I think that sort of presupposes that that headroom is permissible to be added onto rentals
25 and I am not sure that is the case. That seems to be essentially what an aggregation
26 approach would suggest but, as I have mentioned, I think that leads to distortions.

27 Q If it could be done individually, coming back to the same point really, how can there
28 possibly be economic distortions if you do it in ----

29 A I think that is your example of if the DSACs are 10 and 10 and you charge 20, what is the
30 difference between charging 10 and 10 and charging 8 and 12? I think that is sort of your
31 question really, and what I am saying is that charging 12 can have economic distortions by
32 virtue of the DSAC being 10 and the rental charge being 12 for the various reasons that I
33 have set out in the report and have sought to explain in this discussion. But it is the rental
34 impact of those decisions that is distorting the economic behaviour. I am not saying that it

1 is only possible that the rental charge can cause these distortions, but certainly it is the rental
2 one which, at the point of renewal or extension of the circuit, which is the relevant one
3 because that is the forward looking economic cost which is relevant for these
4 considerations.

5 PROFESSOR MAYER: Can I just clarify that? So I think what you are saying is, even if the
6 cost differential are relatively low but the welfare effects could be very high if the elasticity
7 is a substitution high and a lot of people essentially make the wrong decisions. Is that the
8 point?

9 A That is essentially the point, that the gap between the rental charge and the DSAC can lead
10 to certain changes in behaviour and can lead to changes in which circuit is purchased or,
11 indeed, whether any circuit is purchased at all if it becomes unprofitable to continue to offer
12 that, or, indeed, it can lead to competitive distortions in the downstream market because of
13 the way in which the additional pricing flexibility that the aggregation approach will confer
14 on BT. It has clearly got financial incentives conferred upon it by its vertically integrated
15 status and its SMP status to try and target prices in those parts of the wholesale market
16 where its rivals have disproportionate use of those components. So the more you raise
17 pricing flexibility the more likely it is that BT could act in that way and lead to
18 consequences.

19 MS. LEE: In relation to that, there are other mechanisms aside from cost orientation that deal
20 with questions about discrimination, are there not?

21 A Yes, I understand that to be the case. Yes, that is right.

22 Q So it is not the case that cost orientation has to do that work, is it?

23 A No, but what I am suggesting is that if you have what you might call a more flexible
24 approach to the cost orientation the risk of those issues materialising would be greater. It
25 was not something that I have focused on in great detail in my report, but the example that I
26 just gave whereby BT could raise prices for those components that its downstream rivals
27 use disproportionately compared to BT retail ... that would not be a non-discrimination
28 issue because it could say that it is charging the same price for everybody. It just so
29 happens to be the case that those particular services are disproportionately used by its rivals.
30 Okay, so maybe the non-discrimination provision does not really capture it but it is still an
31 economic incentive that BT may have, and it is still something that it would be able to do to
32 a greater extent, the greater the degree of price inflexibility.

33 Q I am sorry, you said that the non-discrimination obligation might not capture it. I am sorry,
34 on what basis?

1 A Because non-discrimination, as I understand it, and feel free to correct me if I am wrong, is
2 saying that I am going to charge, let's say, Verizon 10 but BT Retail 8. Now, obviously it is
3 not allowed to do that. I am not saying it would be doing that. I am saying that, firstly, if it
4 is charging BT Retail the notional 10 the same as everybody else that actually that does not
5 necessarily mean that you have competitive neutrality because the incentives for BT, as a
6 vertically integrated operator, are very different relative to those of an independent external
7 CP.

8 Q But that is the whole system -- I am sorry.

9 A And then furthermore, obviously the key point actually is that you have a whole range of
10 different products that are used to different extents by different operators.

11 Q But if BT ----

12 A If you -- I am sorry. Can I?

13 Q Yes, I am sorry.

14 A If you raise the prices for the particular services, let's say if Verizon uses BES 1000 and BT
15 Retail uses WES 100, I mean, I do not know if that is true, I am not an expert on which CP
16 uses what product, but what I am saying is that the vertical integration nature of BT could
17 lead to financial incentives to raise the prices for those components and products that are
18 used disproportionately by its rivals relative to itself.

19 Q Again that is likely, I think, to be an issue of law about the extent to which BT can operate
20 in that way in areas where it is directly involved in the activity downstream. Even if it uses
21 a different product, it is involved in the activity and there is certainly clearly an ability to
22 prevent that behaviour by non-discrimination or by Ofcom regulatory power.

23 A Maybe Ofcom is able to prevent that. I would not be so confident that that would be so easy
24 to constrain.

25 THE PRESIDENT: So your point is that the basic non-discrimination is simply charging the
26 same price for the same service?

27 A Exactly, yes.

28 Q So they could select their services on which they raise the rental or the disconnection.

29 A Yes.

30 Q And apply it to those services for which they use less.

31 A Yes, exactly.

32 Q It is a simple point.

33 A And that could apply to products such as WES or BES or it could apply to connections and
34 rentals. So say BT knew that it had a set of customers that were multi-nationals that were

1 going to be around for a long time and it could sign some long-term contracts, well, hey,
2 okay, let's have a high connection charge and a low rental charge. They are going to be
3 paying that for, you know, 15 years maybe. Again these numbers are totally illustrative, but
4 if the other CPs have shorter duration contracts then the obvious incentive for BT would be
5 to have a different balance in relation to those charges and it would not be non-
6 discriminatory because, if it did use those other services, it would be charging itself the
7 same amount.

8 MS. LEE: But it could do the same in relation to an aggregate. It is not a point about
9 aggregation, is it? You could do the same for DSAC or DLRIC, if you are really intending
10 to behave in that way. The point is not one that is relevant to aggregation as such, is it?

11 A No, I disagree with that. I am not saying that aggregation or disaggregation would rule out
12 that type of behaviour. What I am saying is that the additional price flexibility that
13 aggregation would confer, for example, by allowing them to raise the rental charges above
14 DSAC, exactly in this situation I just mentioned -- Let's say the example was the other way
15 round, for example. Let's say that BT had a lot of short term contracts and it wanted to
16 have, therefore, a rental charge that was pretty high because it knew its downstream rivals
17 were paying a lot of rentals disproportionately compared to connections. Then the
18 aggregated approach would give it more flexibility to implement that particular strategy and
19 cause distortions in the downstream market, so it is related.

20 Q But everyone would have paid a connection and a rental.

21 A But not in the same proportion. That is my point, is the fact that different CPs buy things in
22 different proportions, both between themselves but also vis-à-vis what BT Retail implicitly
23 buys, leads to these sorts of vertical integration incentives which can be exacerbated by a
24 greater degree of price inflexibility through aggregation.

25 Q But the different proportion point is really a point about the length that the contract goes on.
26 Everybody does pay a connection at the outset of the contract?

27 A Yes. Sorry, perhaps I could just make a slight comment on that? Yes, at the beginning of
28 any circuit you would pay a connection. However I understand, and this is from the factual
29 witness statements, that there can be discounts for connection in certain regards, perhaps
30 when there is a new ----

31 Q Is this migration that you are ----

32 A Yes, yes. There is a migration discount. I think there is a further discount for early
33 migration. I do stand to be corrected on that.

34 Q You make the point in para.47 of your statement about the possibility of migration and the

1 possibility of reducing connection charges in offers.

2 A Yes, that was the point.

3 Q There cannot, can there, be anything wrong in reducing a connection charge in order to
4 encourage migration to a new more efficient technology?

5 A My point is not that there is anything wrong with that, and there may be some good
6 economic justifications for doing so. My point is that having a greater degree of pricing
7 inflexibility through aggregation would allow the sorts of behaviour that I identified, for
8 instance BT targeting the higher charges on those components that its rivals are going to be
9 using to a greater or disproportionate extent.

10 Q But again that is a point, is it not, that is corrected for by the EoI undertakings and the
11 requirements about information and the whole structure for non-discrimination obligations.
12 It is a discrimination point. It is not a point about ----

13 THE PRESIDENT: We have spent quite a lot of time on this point.

14 MS. LEE: Yes, I am sorry.

15 THE PRESIDENT: If you want later to make submissions on the non-discrimination and the way
16 it operates, but I think Mr. Holt has explained his reason.

17 MS. LEE: Yes. Did you look at the second witness statement of Mr. Jones dealing with WES
18 10?

19 A No. Sorry, this was? No, I did not look at that in any detail. Can you remind me what that
20 says?

21 Q I am not sure we need to turn it up, but in relation to the rebalancing that occurred in
22 relation to WES 10 the disadvantage was to BT downstream rather than to the other CPs.

23 A I have no basis to challenge that. Sorry.

24 MS. ROSE: I am sorry, but that is not correct.

25 THE PRESIDENT: I think if you want to make a point on Mr. Jones' witness statement you can
26 make that later. If you want Mr. Holt to comment on something which he has not read then
27 you have got to give him a chance to look at it.

28 MS. LEE: Yes, Sir. I think those were my questions. I am sorry, there was one question that I do
29 want to ask, which was in relation to your point about reliance on the RFS by disputing CPs,
30 I was going to say this. You would accept, would you not, that when they set the prices
31 they are not relying the RFS for that year because that RFS has not yet been produced?

32 A I am sorry, are you saying that would BT be able to rely on the RFS?

33 Q No, no, the disputing CPs.

34 A Oh, disputing CPs. I do not know as a matter of fact exactly what the timetable is for the

1 production of the RFS, so if there is a lag then they will have to use the latest one that they
2 can get their hands on, yes.

3 Q You have made a point in the experts' summary at 1.4, p.6.

4 A Yes, I think I have got it in this bundle. So 1.4?

5 Q Page 6.

6 A Thanks.

7 Q This is the area that leads into Mr. Read's area, so I am just going to ask a couple of brief
8 questions about it.

9 THE PRESIDENT: I am sorry, can you give me the reference again, please?

10 MS. LEE: It is 1.4, p.6. You say there that:

11 "... the RFS was the only way for competitors to assess whether BT is adhering to its
12 regulatory requirements of pricing at or below DSAC".

13 Have you looked at the RFS in detail?

14 A Not in detail, no.

15 Q Would you accept that it is possible to work out from the RFS what total connections and
16 rentals revenues are and what the aggregated DSAC would be?

17 A I think, to be honest, I would have to look at something tangible to assess whether that
18 would be possible, but yes, it depends what actual information is published in the RFS, but I
19 do understand that the RFS is the main source of regulatory information on which Ofcom
20 relies to enforce cost orientation.

21 Q Well, if you have not looked at it for that purpose, I am not going to ask you about it.
22 Thank you.

23 MR. READ: Sir, you did say that there might be a break. I do not know whether you want me to
24 go straight in or whether you want a break. There will just be a little bit of shuffling while
25 we change over.

26 THE PRESIDENT: We will take 10 minutes now, until five to.

27 (Short break)

28 THE PRESIDENT: Yes, Mr. Read.

29 Cross-examined by Mr. READ

30 Q Mr. Holt, as you already know, I am asking questions on behalf of BT in respect of the
31 fourth section of your report.

32 A Yes.

33 Q It is fair to say, is it not, that your report starts with the basis of a number of assumptions
34 about BT's position. We see that in para.94 of your report bundle D tab 12?

1 A Yes.

2 Q I just really want to understand the basis on which you have looked at these nine items that
3 you have in para.94 of your report and what information you basically had in respect of
4 them . Perhaps we can start with the first one on p.32, which is your second bullet point
5 where you say that BT has a degree of discretion in how it allocates costs, yes?

6 A Yes.

7 Q That plainly is not an unfettered discretion, is it? There plainly are limitations on it?

8 A Yes, there would be limitations, one would expect.

9 Q You are an economist, but the RFS is principally going to be administered by accountants?

10 A That's probably fair to say, yes.

11 Q They plainly all, if they are qualified accountants, have a set of professional obligations that
12 they have to perform to in carrying out their duties?

13 Q I would agree with that, yes.

14 Q You had not seen Mr. Dolling's statement when you wrote your report?

15 A That's right.

16 Q Have you had an opportunity to see Mr. Dolling's statement?

17 A I have briefly reviewed it, but not in any great detail.

18 Q He effectively says that there are quite a few constraints on BT as to how it can allocate its
19 costs, one of which (which was explored with him in cross-examination on the second day
20 of this hearing) was that the judgments that they carried out relating to the distribution
21 discretion of allocation of costs was made with a great deal of care and professionalism.

22 A Right, I have no basis to disagree with that. I'm sure that's what BT tries to do, yes.

23 Q But when you were drafting your report, had you really focused on the extent to which the
24 fact that this was being administered by professional accountants would actually constrain
25 the amount of discretion BT had?

26 A No, I didn't draft the report with that in front of mind. What I was thinking is that to the
27 extent that there are some potential alternative options that they could select from, that there
28 may be a degree of discretion as to which particular rule is applied in which particular case
29 and no more than that, really.

30 Q When you answered Ms Lee, I think you indicated that you really had not looked in any
31 great detail at the regulatory financial statement?

32 A That's right; that's fair, yes.

33 Q I just wanted to see whether you understood that the fully allocated costs within the
34 regulatory financial statements are in fact independently audited?

1 A OK, I'm happy to take that as right.

2 Q Would you accept this (because presumably you have read the Decision at some length, i.e.
3 the Decision of Ofcom in this case), that most of the adjustments that are actually made by
4 Ofcom in the course of the Decision have first to be made through the fully allocated costs?
5 Basically, they adjust back and then having done that, they work through to adjusting the
6 DSAC? If you want to have a look at it I will turn it up.

7 A Sorry, is the question am I familiar with that detail as to exactly how those changes that
8 Ofcom has proposed have been --

9 Q Yes.

10 A I think the first point to note here is that, as I state I think early in section 4, I haven't
11 reviewed the detail of the specific proposed changes. What I have done – I just want to
12 make sure the scope of what I was looking at is known to the Tribunal – is think about the
13 wider consequences of permitting changes to the RFS in the context of the cost orientation
14 dispute. That is the focus.

15 Q One can see that you have set out your economic considerations in the abstract.

16 A Yes.

17 Q But the problem is that there is a real case going on here, and there are real issues about how
18 the RFS operates, how exactly it is controlled by Ofcom, and you have made your points on
19 a number of assumptions that you have set out in the course of your report, particularly in
20 the bullet points and in para.94, and I want to see how much you have actually considered
21 the specifics of this particular case. By the sounds of it, you are saying you have not
22 considered it in any great depth at all?

23 A Yes, that's what I say in my report.

24 Q Can I ask you to be given bundle BT27 tab 25. That should be the current costs, financial
25 statements for 2009 Do you have that?

26 A Yes, I do.

27 Q The first thing I would ask you to note is that on the first page overleaf (I do not think it is
28 actually numbered) you see that Ofcom itself is making a statement on BT's current costs
29 financial statements?

30 A I do see that, yes.

31 Q Including, for example, para.3:

32 "These regulatory Financial Statements include some important new developments
33 and improved disclosure. We welcome BT's commitment to make these
34 improvements which often involve significant effort to make the necessary

1 changes to systems and processes"

2 So Ofcom itself is having an input into this RFS, is it not? That is why they have got a

3 statement there.

4 A Yes, I don't know the extent of that input. I mean, they have clearly got a statement here,

5 yes that's clear.

6 Q Let us go on to p.11, shall we? This is the audit report of the independent auditors. At

7 paras.7, 8 and 9 they basically set out what it is they are actually doing. Given the time, I

8 am not going to read it at length to you, but then on p.13 we see that they give an audit

9 opinion on various matters. I am quite happy to accept the point that was made yesterday

10 by Mr. Pickford that the DSACs per se are not audited, but the FAC costs are.

11 A OK, I'm happy to accept that as well.

12 Q So BT actually has not only to deal with its own professional internal standards that the

13 accountants feel they must meet; it also has to deal with an independent auditor and

14 convince the independent auditor whether or not any changes it is making to its RFS are

15 acceptable. You would accept that that actually is providing quite a significant constraint

16 on what BT can do about flexing its RFS?

17 A That provides a constraint. I'm not in a position to comment really on the extent of that

18 constraint because I don't know exactly what Ofcom would have done in terms of input to

19 the statement in terms of detailed review. I also don't know the extent to which BT would

20 have the flexibility to explain different approaches to the auditors and demonstrate what

21 they are doing. So I'm not disagreeing with you. All I'm saying is that I don't really have a

22 strong view as to the extent to which these constraints would limit what they can do. But

23 clearly there would be some constraint, yes.

24 Q But it is an essential premise of your argument that BT may have financial incentives to

25 allocate costs in a way to gain commercial advantage?

26 A That is one of the points I make, yes.

27 Q You make it again in the joint expert statement, after you had seen Mr. Dolling's statement?

28 A I hadn't actually seen Mr. Dolling's statement at that point in time. I'm sure it was available

29 at that point in time but I hadn't seen it. Yes.

30 Q I just want to see how this works in practice. Perhaps we can just turn up the joint statement

31 which is earlier in the D bundle you have. Can I say that BT 27 can be put away. It should

32 be at tab 1.3.

33 A Yes, I have that.

34 Q If we just look at p.5 for example, you say there, do you not, that BT may have financial

1 incentives to allocate its costs in a way to gain commercial advantage. We see that on the
2 left?

3 A Yes.

4 Q On the right we see Dr. Maldoom's response:

5 "To allocate costs in a 'strategic' manner with a view to making subsequent
6 adjustments if a dispute is brought is risky for BT as there is no certainty any cost
7 adjustments will be accepted by Ofcom (see section 3 below.) BT enjoys no
8 obvious benefit from understating costs and then adjusting them up if a dispute
9 arises..."

10 So he is effectively saying that there is no obvious advantage at the stage that the RFS is
11 compiled for understating costs in the expectation that you might actually crease
12 subsequently?

13 A I'm afraid that statement which is attributed to me is actually not one that I made. The point
14 that BT would enjoy benefit from understating costs, and then adjusting them upwards was
15 not part of the strategic behaviour that I had identified could happen.

16 Q But I thought part of your thesis (if I can call it that) is that BT can effectively flex its RFS
17 at the time in order to get benefits, and then you can only prevent that if you actually put a
18 check on BT, making later adjustments in order to incentivise BT at the time of the RFS not
19 to flex its accounts in that way?

20 A Sorry, I'm not quite sure I follow the line. My incentive point is that BT has a number of
21 financial incentives and it has an informational asymmetry in its favour. That can lead to a
22 whole range of things which I've set out in the report. I don't need to necessarily go through
23 them all now, but essentially in brief, to allocate costs to the charge controlled items in
24 preference to the non-charge controlled items, to allocate costs to those charges that are
25 subject to cost orientation where it has a preference for a high price rather than a low price,
26 and then to do the converse where it has a preference for a low price, for instance where it is
27 seeking to derive some competitive advantage through low prices.

28 Q You are saying that that advantage is at the time it is compiling the RFS, are you not?

29 A Well, there's probably a number of periods of time in which these would materialise.
30 Firstly, in relation to when it's compiling the RFS because more costs being allocated into
31 charge controlled services will help in terms of its future charge control debate with Ofcom.
32 But also in relation to when it actually sets charges, it would have particular incentives. So,
33 for instance, just leaving to one side the RFS for the moment, it would have particular
34 incentives to have higher prices for certain activities and lesser prices for others. I sort of

1 mentioned the reasons for that in the previous part of the discussion around which CPs are
2 disproportionately using which services and so forth.

3 Q But the way you are putting it in section 4 of your report is that it is at the point of the RFS
4 that it is important that BT allocates correctly its costs, on your thesis.

5 A Yes, so in relation to the RFS that is indeed what I'm saying, and furthermore, the
6 possibility of making changes to the RFS can have some negative consequences.

7 Q But if BT is restricted in what it can do at the time of the RFS, a great deal of the concern
8 you have about it subsequently adjusting the RFS disappears, because it has not gained the
9 commercial advantage you are talking about in the first place.

10 A One of the sources of commercial advantage would have not materialised if it has, let us say
11 correctly (I use that word in a very general sense) developed the RFS. So yes, I agree with
12 you in that regard. However, I think I disagree in relation to the fact that no benefit can be
13 derived because one further source of distortion that arises is that BT could raise certain
14 prices higher, or perhaps even above, the DSAC for a particular charge, and if it has the
15 opportunity to make a later change to the RFS, then that behaviour would be more
16 profitable. So that particular distortion or incentive that I'm talking about does not actually
17 rely on the original decision in terms of how the RFS is constructed; it relies on the original
18 pricing decision and then furthermore on a subsequent change to the RFS to effectively help
19 justify the original pricing decision.

20 Q Let us just take this in stage, because at the time BT sets its price it will not have the RFS
21 compiled for the year in which the prices have been set. You would agree with that
22 proposition?

23 A I assume that that's the case on the basis that you have put it to me, yes.

24 Q So BT then has a series of prices and volumes that have been set, and the reason why I
25 mention volumes that are derived from the prices is because in the RFS the amount of
26 volumes for different products drives the various allocations?

27 A Right.

28 Q I will not take you at length through that to actually demonstrate that, but that is a principle
29 we can see in some of the other features of this case. That is what happens, that the
30 volumes drive the allocations?

31 A Okay.

32 Q In other words, if you have more of a product being sold, that catches more of the cost when
33 it comes to allocating how the cost should be spread?

34 A Yes. Can I just ask a question at this point?

1 Q Certainly.

2 A My understanding would be that that may be one source of allocations - in other words, a
3 volume related cost driver must be an important feature but there may otherwise be other
4 drivers as well.

5 Q I am certainly not saying it is the only thing that drives the allocations, I am just saying that
6 volumes do drive, or help to drive, allocations. That pricing and that volume material is
7 effectively independent of what happens when the time lag comes for BT to actually
8 compile its RFS, and you accept that the RFS is quite a complicated exercise - I think that is
9 what you say?

10 A Yes, I do.

11 Q What I am putting to you is that in order for BT to effectively juggle the figures in BT's
12 interests, it would have to go through a lot of complicated processes in order to achieve
13 what it wanted to achieve. It would effectively have to second-guess volumes, it would
14 have to second what the auditors might say, it would have to second-guess what its own
15 accountants might say about it. The point I am putting to you is that the reality of this
16 situation is that it would be extremely difficult for BT in any way to manipulate the RFS?

17 A Well, you're making a proposition. I'm not sure that I can agree with it or not without being
18 in BT and understanding the full set of constraints. All I am saying is that BT would have
19 some informational advantage over CPs who are obviously competing with it, and Ofcom,
20 who is effectively monitoring the SMP conditions. I don't think anyone is challenging that
21 BT would have that informational advantage, but correct me if I am wrong. Is that what
22 you are suggesting?

23 Q We will come to that in a moment, but what I am saying is that from BT's own point of
24 view, trying to predict what services to drop the costs allocations on and what services to
25 put them up on in order to get a benefit would be a very complicated exercise for BT to
26 achieve?

27 A It may well be. I haven't really assessed the degree of complexity it would have to go
28 through. Again, all I am saying is that it may have financial incentives along the lines that
29 I've explained.

30 Q One of the essential elements, I think, of the thesis that you are putting forward is that BT is
31 in a position regularly, as a result of this information advantage, to restate its accounts?

32 A I don't think I recall certainly putting the qualifier "regularly" in there. I think all I'm saying
33 again is that it may have financial incentives to allocate costs in a particular way to gain
34 advantage, and it would furthermore have financial incentives to make adjustments to the

1 RFS, particularly in relation to price or cost orientation disputes which have arisen.

2 Q I am just looking at para.95 where you see, where you see, "BT has in the past made
3 changes to the RFS", and then you set out three changes. This is para.95, p.32 of your
4 statement, tab 12, bundle D.

5 A Yes.

6 Q You list out a series of changes there. I note that you seem to be relying on this from the
7 witness statement of Mr. Scott, because you have a footnote at the end of that paragraph
8 where you say, "See first witness statement of Colin Scott", and you also in several other
9 places in your expert's report also refer to Mr. Scott, including footnote 34:

10 "Colin Scott provides examples of how recent changes to the RFS may have been
11 to BT's commercial advantage."

12 So one question I want to ask is: to what extent are you actually relying upon what
13 Mr. Scott has said as the basis for your views?

14 A Well, I think what he's identified are some factual examples of changes to the RFS. What I
15 am doing is saying from an economic perspective, what are the incentives that BT would
16 have, and the facts seem to support the economic considerations that I have identified.

17 Q I just want to explore the first one that you have listed in your first bullet point in para.95,
18 and I wonder if you might be handed bundle DF1, and would you go to tab 8, which is a
19 regulatory financial statement made by Ofcom. Did you know that each year Ofcom
20 consults on what changes it might make to the regulatory financial statements, and then
21 publishes a final statement of which this is one example for 26th June 2008?

22 A No, I wasn't aware of that, no.

23 Q If you look at p.2 of the actual document, you can see there is an several summary and at
24 para.1.7 you can see:

25 "The table below summarises the objectives addressed in this statement and our
26 final decision taking full account of the responses to our consultation."

27 You can see in the fourth row down,

28 "Matching revenues and costs.

29 We have found that in some markets the immediate recognition of revenues for
30 sales of equipment does not match the costs of that equipment (depreciated over
31 their estimated economic life). This impacts the interpretation of profitability in
32 those markets."

33 Then the next one:

34 "Reporting on leased lines – addressing some of the findings set out in annex 13

1 (Replicability and the PPC charging model) of the Business Connectivity Market
2 Review (BCMR) We concluded last year that there should be a number of
3 improvements in BT's regulatory reporting for Partial Private Circuits (PPCs) ..."

4 We can see on the right hand column against that row what is being suggested. Mr. Dolling
5 in his statement says that this was one of the major factors why BT changed its regulatory
6 accounting policy in 2007/2008, and that is para.103 of his statement. Were you aware of
7 any of this when you were actually writing about the incentives?

8 A No. Can I make a comment at this point?

9 Q Yes, certainly.

10 A I was aware that Ofcom has a role in potentially approving or monitoring the RFS, as it does
11 more generally for BT. My point is not that Ofcom has no ability to review and make
12 interjections, it is that BT has a greater ability than Ofcom. That's really I was saying.

13 Q In the sense that obviously BT can dig and dig and dig into its figures and try and come up
14 with the information, then obviously that is right.

15 A Right, that's all I was saying.

16 Q Yes, but it all depends ultimately, does it not, when you are on your incentive effects, the
17 extent to which Ofcom and other factors control the events?

18 A I agree with you that one of the constraints on BT's ability to act in the ways that I've
19 identified would be how effective is the regulatory monitoring regime of the RFS detail, and
20 the auditors may have also a role in doing that. So I think I agree with you in that regard. I
21 think my only point is that I'd be highly surprised if those constraints meant that the
22 financial incentives that I've identified are impossible for BT to follow up on. If that is
23 factually the case then I'd be happy to agree it, but the fact that Ofcom and auditors look at
24 the RFS and produce a report does not in any way in my view fully counteract the financial
25 incentives that I've identified.

26 Q I am just looking at the first example you have given in your first bullet point in para.95.
27 You appear to be making and relying upon a point that BT has restated the volumes and
28 revenue data for 2006/07. We have seen that they had to make the adjustment to the RFS in
29 2007/08, and having done that they had no option but to restate the 2006/07?

30 A If that's the case then that may well be true. I don't know that to be a fact, but I'm happy to
31 accept that that is the case in that instance.

32 Q I appreciate that accountancy is not your domain, but surely you know that in general that
33 where a company at some point has had to changed the basis of its accounting for a
34 particular year, it generally has to restate the accounts for the previous year in order that you

1 compare like with like?

2 A Well, I've seen that companies from time to time do restatements of accounts.

3 Q Did you know that BT was under a specific accounting obligation imposed by this RFS
4 scheme to do just that? So it was not just normal accounting principles, it is was actually a
5 specific direction and, if need be, we can look at that?

6 A I am happy to accept that.

7 Q Can I ask you then to look at para.96 in your report. This is your point about Ofcom's
8 power to make adjustments, and you say at the end of that:

9 "However, these are relatively limited in their wider context of the overall
10 regulatory control base, and Ofcom historically has only rarely intervened in BT's
11 RFS, for example when it is necessary to do in the course of resolving disputes."
12 We have just seen one example of Ofcom intervening. Can I ask you now to take BT7, and
13 go to tab 12. This, I should add, is the full version of the Leased Line Charge Control from
14 2009. Is it a document that you are familiar with?

15 A Not in any great detail, no.

16 Q Would you go to p.95, for example. You can see that there are a series of changes that
17 Ofcom propose to make to BT's costs data for the base years 2006/07, and this is in respect
18 of what is called the TISBO market.

19 A Yes.

20 Q And if we look at table 4.2, for example, on p.97, we see the adjustments that are made?

21 A Yes.

22 Q Or considered, I think it is fair to say, because not all of them were actually made.
23 Likewise, if you go on to p.147, we see the same basis for the AISBO market and the
24 changes there are in table 5.2 at p.149. This was not a pricing dispute, as is the nature here,
25 this is a full blown market review where Ofcom has clearly dug quite deep into BT's RFS.
26 You would agree with that?

27 A Yes.

28 Q So it is a clear instance of Ofcom exercising the sort of regulatory supervision on the RFS
29 that you seem to suggest has only rarely happened?

30 A It's clearly an example of them doing that, yes.

31 Q Were you also aware that Ofcom does not just rely upon BT's own data when it is actually
32 making these adjustments, it has, on occasions, commissioned independent analysis. Were
33 you aware of that?

34 A No.

1 Q You can put that bundle away, and can I ask you to take BT8, tab 17, which hopefully
2 should be the BT RFS for 2008, which is the year before we were looking at previously. If
3 I ask you to look at p.1, you can see at para.1.4:

4 "We had already identified some concerns in 2007 about the approach used by BT
5 to calculate PPC revenues as part of our review."

6 I want to make clear that this is actually before the PPC dispute, as we now know it, came
7 to the fore, so this is nothing to do with the PPC dispute, as such. You can see that they go
8 through it at some length, and if you just pick up para.1.6:

9 "BT's 2007/08 results in leased line market now reflect the revised revenue
10 calculation methodology."

11 That is following on from the statement that we have just looked at, so this RFS follows on
12 from the Ofcom statement we looked at a bit earlier.

13 "BT has also updated the supporting documentation (the Accounting Documents)
14 to reflect this change so that users can understand the approach followed."

15 So Ofcom is saying "We are actually allowing this to be transparently seen by users - yes?"

16 A Yes.

17 Q I will come back to that point in a minute, but if you look at para. 1.8 you can see that
18 Ofcom says:

19 "Given the importance of this issue, we have also commissioned an independent
20 consultant (Analysys Mason) to test the accuracy of the new calculations, review
21 and comment on the volume measures used..."

22 So you were not aware that actually that sort of investigation had been conducted by Ofcom
23 itself when you wrote your report?

24 A I wasn't aware of that study, and I'm not surprised that Ofcom spends resources trying to
25 monitor the RFS and any changes to it. I accept all of the points that you are making are
26 illustrations of how Ofcom seeks to do that, and I think all I would say is, yes, you would
27 expect a regulator to do that given the importance of the RFS, but I would be highly
28 surprised if that meant that BT had no residual flexibility to act on the incentives I have
29 identified. These are clearly things that Ofcom has identified. What I am saying is that
30 there may well have been other things that Ofcom has not.

31 Q You wrote your report on the premise that Ofcom only rarely intervened in BT's RFS?

32 A I'm happy to accept that these are clear evidence of intervention that it has made.

33 Q And that BT had made a number of changes in the past but as we see, because that is your
34 para. 95 to its RFS, but we see, and I will not take you through all of them, but certainly for

1 the first bullet point you rely upon it was not BT actually making the change, it was Ofcom
2 directing BT to make the changes?

3 A Right.

4 Q Can I ask you now about the limitations on the CPs to challenge BT's assumptions and
5 methodology in the RFS, which I think we can pick up at a number of places in your report,
6 including the seventh bullet point at para. 94. You could agree this proposition, I think, that
7 the CPs in these cases had a great deal more information than the competitors in a normal
8 market can glean from publically available accounts?

9 A The RFS goes beyond what a normal set of accounts would produce.

10 Q It goes substantially beyond what you would normally expect, would it not?

11 A Sure. Can I make a point at that point?

12 Q Yes, certainly?

13 A It may be that the industry is far more complicated and the vertical integration issues mean
14 that the importance of that information is far greater.

15 Q I do not need to debate with you why it is there, I am just say that, as a fact, it is much wider
16 than.

17 MS. ROSE: I am very sorry to interrupt my learned friend, but the last proposition was put on a
18 false factual basis. It was put that the restatement to the RFS in relation to the PPC
19 revenues was as a result of a direction by Ofcom. That is not the evidence of Mr. Dolling.
20 Mr. Dolling's evidence was that the restatement resulted, at least in part, from a decision by
21 Ofcom. That is para. 106 of his witness statement.

22 MR. READ: If I did not make it clear that Mr. Dolling was not saying that it was the complete
23 reason for it then I accept what my learned friend says, but he does say that that was a
24 reason why they restated the volume and revenue data to the PPC and AISBO which is what
25 you comment upon in para. 95, but perhaps we can deal with that on submissions
26 subsequently.

27 Are you aware of the primary accounting documentation and the material that goes behind
28 it?

29 A I am aware that there is a whole set of different documentation, including allocation rules
30 and so forth. I haven't reviewed all that in detail.

31 Q I just want you to look at one document. It is BT vol 28, and it is actually also, but you do
32 not need to get these out, it also goes on because it is so big to BT vol. 29 and BT vol. 30,
33 but thankfully I do not think we will need to look at those.

34 A This is the detailed attribution reference, yes.

1 Q Yes, and if we just look, for example at the second page, which sets out the contents we can
2 see the length it actually goes to, it runs to I think about 1700 pages. If we perhaps go on to
3 p.7 we can just see an introductory guide to using the detailed attribution methods. It says
4 that readers should familiarise themselves with different types of cost ... and layers of
5 attribution as described in the conceptual model in s.3 readers can then follow the flow of
6 cost for a chosen sector of BT's business by starting at the lowest level, source, cost
7 revenues, assets, liabilities and following attribution process through sections of the ...
8 I could, but I will not because of the time, take you at some length through this document.
9 A document of that sort of length does allow a great deal of transparency about what BT is
10 actually doing, does it not?

11 A There is a lot of detail, obviously in order to get to grips with exactly what they're doing on
12 any particular set of costs might be a highly complicated issue to try and get to grips with. I
13 am glad you're not taking me through this because I don't think I've had much opportunity to
14 comment on detail without spending, I would imagine, some weeks to try and assimilate it.

15 Q I think I can do it simply by asking you to look at the transcript bundle for day 2. If you
16 look at p.35 it is where Mr. Dolling summarises, this is at line 17?

17 A Yes, I'm there now.

18 Q Where there is a question asked:
19 "Q They only know what BT chooses to publish about costs, its costs and
20 revenues and allocations, do they not?"

21 A Yes, but the regulation, I can go through the tabs in my witness statement if
22 need be, sets out both the primary accounting documents where we give an
23 overview, the detailed and secondary accounting documents, the detailed
24 attribution methodology, which is several hundred pages, and there is a
25 transparency principle that is required by Ofcom such that any relatively informed
26 financial and regulatory person, from the information which we have published,
27 would be able to reproduce the regulatory accounts and attributions, and that is one
28 of the points that is tested by the auditors."

29 You have nothing to challenge Mr. Dolling on when he says that?

30 A No, I don't have anything to challenge Mr. Dolling on that, no.

31 Q Were you also aware that actually people in the telecoms markets move around quite
32 regularly. That is what Mr. Scott said in his evidence ----

33 A That's right.

34 Q -- and, indeed, there was a reference to one BT person, Anne-Marie McDonough, who

1 moved from BT to Virgin. I do not know how well you know the telecoms sector ----

2 A I am not unaware of it, people move in and out of the sector and perhaps within, across

3 companies.

4 Q So that will allow a cross fertilisation of ideas and information?

5 A Sure.

6 Q Did you know that the CPs also have an opportunity to effectively ask Ofcom or put

7 representations in to Ofcom to force BT to provide more data? Were you aware that that

8 was the process?

9 A I am aware that they can raise various types of matters with Ofcom, various complaints and

10 disputes and so forth, so it doesn't surprise me that they can raise issues of that nature, yes.

11 Q And so it is not simply a one way process, is it, because the CPs, if they feel that they are

12 not being given information can put requests into Ofcom, and Ofcom can adjudicate

13 whether those requests are fair or not?

14 A Yes, that sounds reasonable, yes.

15 Q Would you accept that the CPs themselves can make quite detailed challenges to the RFS in

16 the course of the dispute resolution process?

17 A Sure, I am sure they would try and do their best to challenge it and they might spend a

18 degree of resource in doing that. I am not really disagreeing with any of these propositions

19 that you are putting. I think my overall point is actually a very simple one which is that BT

20 has its hands on the pulse of the RFS, the others can only contribute by monitoring and

21 asking questions, so that gives BT an advantage and, really, that's all I'm saying.

22 Q But the extent of that advantage must necessarily depend upon the balance between the

23 parties?

24 A Yes, I agree.

25 Q And it must necessarily depend upon the constraints that BT operates under?

26 A I agree with both of those statements and all I am saying, again, is that I would be very

27 surprised if the balances and constraints are sufficient on the one side of the ledger to

28 counteract the clear fact that BT is the one producing with the finger on understanding

29 exactly what it is doing.

30 Q Because another step in your argument is that you say BT has particularly strong incentives

31 to highlight errors in the RFS following an announcement of a price dispute. That is one of

32 your central premises, is it not?

33 A Yes.

34 Q You make that at several places, but including at para. 103 in your report?

1 A Yes.

2 Q Now, obviously if something is found to be wrong then one might expect BT to raise it, you
3 would accept that principle?

4 A Yes. Well, sorry, can I qualify that?

5 Q Yes?

6 A If something is wrong BT will almost definitely raise it if it is in its favour. It may or may
7 not do so if it is not in its favour.

8 Q One of the points though about the dispute resolution process which you may or may not be
9 aware - well, let me ask it as a question - are you aware the level of scrutiny that has gone
10 on in the course of these disputes about cost orientation about BT's figures?

11 A I am aware that there's been a long standing complaint and whole set of consultation
12 documents and so forth, so I would imagine that it's been an extensive process.

13 Q You see, is not one of the features that if you actually shine a spotlight on figures and the
14 like in the course of a dispute in the way that it has been in this case and, indeed, in previous
15 instances, that errors will come to light, not because someone is trying to flex them, it is
16 simply because there has been a spotlight shined on the accounts that bring into focus issues
17 that otherwise would not have been discovered?

18 A I would agree with you that it is more likely that errors will be identified under a higher
19 degree of scrutiny than if there is none, yes, I agree with that. I think my point again is that
20 BT's incentive will be to identify those errors that work in its favour, disproportionately
21 relative to ones that work against its favour. Furthermore, it may well be that CPs or Ofcom
22 can identify some errors, but their ability to do so will naturally be bounded by the amount
23 of resource that they have and their understanding of the detailed approach that BT takes.

24 Q You have obviously not looked in any degree as to the level of detail that Ofcom has
25 actually gone into in its scrutiny ----

26 A I have not, as I think I said before.

27 Q Can I just ask you to take bundle BT31 and go to tab 13. Incidentally, I should say, Mr.
28 Holt, you are in the confidentiality ring, are you?

29 A Yes, I am, yes.

30 Q Thank you, I am very grateful for that. We do not obviously want you to refer to any of the
31 figures that have been blueed out on this document?

32 A Sure.

33 Q This is a sort of information response to, I think, three questions that were asked, and there
34 were a lot of other questions asked as well. Perhaps if we just look at p.7, and if we look at

1 that we can see that this question all relates to effectively a change to BT's investment in
2 21st century network, and how exactly the costs should be excluded, and you can see there
3 that there is, in fact, a spreadsheet in which BT provides the answers?

4 A Yes.

5 Q Then over the page, for example, at Question 13c, we can see the question actually:

6 "provide, using the methodology described in the Competition Commission's
7 determination between Cable & Wireless and [Ofcom] on 30 June 2010, analysis for
8 which 21CN costs (both P&L and MCE) are truly specific to 21CN";

9 And BT give an answer. What one sees from that that actually the Competition
10 Commission have actually looked over the question of the calculation of costs in this
11 particular instance.

12 A Yes, I see that. Yes.

13 Q So when you were considering this information asymmetry you did not have an idea at that
14 stage about the sort of level of detail of figures that was actually being investigated?

15 A Obviously I am aware of a whole range of disputes in Competition Commission enquiries or
16 pricing disputes and charge control disputes which have been referred to the Commission
17 and so forth, so it is not surprising to me that there has been that level of rigorous analysis
18 of some of those numbers. So I accept that, yes.

19 Q But would you not accept that part of the problem with all of this is that you can list a thesis
20 about what the incentive effects may be, but it does not give you any sort of answer unless
21 you know what the constraints are, what the information that has been looked at, at what
22 else has gone on in terms of the RFS and general investigation into figures? Unless you
23 have actually ploughed through that material, you cannot actually come up with a view as to
24 how much weight one should give to any incentive effect?

25 A I agree I cannot quantify that and I cannot measure the extent of the constraints that the
26 other parties may be able to impose. What I can, however, say is that on the basis of my
27 career, which has involved essentially advising regulators and regulated companies over 18
28 years, and also I would say during that time thinking about regulatory issues, is that
29 information asymmetry is one of the central problems of regulatory interaction between a
30 company and its regulator. So I do not see why BT would be any different than that. Yes, I
31 do accept that there is a framework, a whole set of detailed investigations that have gone on,
32 but what I would not accept from that is that that necessarily means that all errors will come
33 to light or that Ofcom will be able to identify them. There may well be other ones which
34 may be in there that they have not been able to identify purely on the basis that they

1 obviously do not have infinite resources.

2 Q How much scrutiny of the telecoms sector have you actually had?

3 A I have been involved in a number of charge control disputes as an adviser and also, in earlier
4 times, I have actually worked, while in my previous firm, we worked with companies that
5 were involved in the sector. So I have had a fairly significant number of projects which
6 have been in the telecoms sector.

7 Q But prior today you do not seem to have been aware, for example, that the RFS was audited;
8 you do not seem to have been aware of the process by which the RFS is drawn up; you do
9 not seem to have been aware about the changes that Ofcom has done in the past and the
10 Lease Line Charge Control. You see, I do not want to in any way belittle your experience,
11 but I am asking you, that you are having to look at a specific equation here and a specific
12 context, and I want to see really how often you have actually looked at this question in the
13 context of the RFS.

14 A I actually refute the suggestion that I would have to look at a particular equation. I actually
15 state quite clearly that I have not looked at the particular equation. What I am doing is
16 using my general economic and regulatory expertise to identify the incentive effects that
17 would arise in relation to the sorts of issues that BT is raising here.

18 Q Can I ask you ----

19 A That is all I have tried to do ----

20 Q I am sorry, carry on.

21 A That is all I have tried to do in this section. I have tried to say it a few times.

22 Q I am very conscious of the time so I am going to ask you one final area. I want you now to
23 look at para.111 of your report on p.38 and the final bullet point. So it is in Core Bundle D,
24 Tab 12 and it is at p.38, and your final bullet where you are actually dealing with a different
25 situation, which is where BT puts forward new evidence or reasoning in support of
26 proposed adjustments to the RFS in the context of an appeal from the Ofcom Pricing
27 Dispute Determinations. Yes?

28 A Yes.

29 Q So in fact you are talking about an appeal to this Tribunal?

30 A Yes.

31 Q The first reason you give is:

32 "First, this renders more difficult Ofcom's ability to enforce the SMP conditions if its
33 decisions can be overturned not because of how it took account of evidence available
34 to it at the time, but rather due to evidence which comes to light at a later stage".

1 A Yes.

2 Q I do not want to debate with you issues of law, but let us just assume for a moment that
3 appeals to this Tribunal are on the merits, that new evidence can be admitted, and that the
4 Tribunal has a power to exclude and control any evidence before it. Are you really
5 suggesting that if that is what Parliament intended and laid down, that your incentive effect
6 should over-weigh that?

7 A I am not necessarily saying that they should outweigh Parliamentary issues that have been
8 set up in terms of how an appeal is operated. It was merely to suggest that there are a series
9 of incentive issues that I have highlighted and those need to be taken into account when
10 thinking about what is the set of adjustments that one might permit in this regard.

11 Q You give as your second reason:

12 "The ability of CPs to effectively monitor the cost orientation conditions will be
13 reduced where the ultimate outcome of any challenge is driven by events and evidence
14 produced specifically to challenge Ofcom's decisions".

15 I wanted to ask you about that because in this instance, in fact, the CPs are actually in a
16 much better position than they would be prior because they themselves can ask for
17 information and see it, subject to constraints about confidentiality. Were you aware of that?

18 A Yes, I am aware that they can ask for information but my point is that the main tool that
19 they use to monitor and identify the extent to which breaches of the cost orientation may
20 have arisen is through the RFS. So if you allow for changes to the RFS, that simply makes
21 it more difficult to know what is the likely outcome of any potential dispute that I might
22 bring. Because if I am basing my information on what I am observing but I cannot rely on
23 that because there may be subsequent changes to it, that adds an obvious risk factor to any
24 point that I might bring.

25 Q Do you draw any distinction between instances where BT is effectively saying, "You did
26 not change this, Ofcom. We would want you to change it", from instances where Ofcom
27 has made changes itself and BT says, "No, no, no, there is an error in the calculations or
28 whatever, the way you have carried it out"? Do you see any distinction between the two?

29 A Yes, I acknowledge a distinction in that regard. So clearly the degree of the risk is greatest
30 in relation to issues that BT highlights effectively voluntarily. I think the other type of issue
31 is the ones that you have identified are responsive to what Ofcom is highlighting, and I
32 think the issues still arise but arguably to a lesser extent because obviously the degree of
33 flexibility they would have would then be narrowed, because obviously it cannot raise any
34 particular issue. It has to raise an issue that is specifically relevant to the issue of comments

1 raised. So that might put a bit of a boundary on the degree of flexibility that I have
2 identified. Yes, I agree with that.

3 Q But you still seem to think that those adjustments, BT was to have an incentive and an
4 ability to cherry-pick?

5 A They will have an incentive and an ability to cherry-pick responses to the Ofcom
6 statements, yes, because they can identify things that may support their case against that
7 particular adjustment. They might, in the course of investigating the issues, identify things
8 that actually exacerbate Ofcom's point, but my point is that, because of the asymmetry
9 involved, the fact that they control the information, they will tend to only draw to Ofcom's
10 attention the former and not the later.

11 Q Can I finally just ask you to take one final file, which is BT8, and if you can just look at Tab
12 13. Do you have that?

13 A Yes, I do.

14 Q It should be an letter from BT to Ofcom dated 3rd September 2012.

15 A Yes, I have that.

16 Q If you just go to the final page, p.9.

17 A I am sorry, I have 19 pages.

18 Q I am sorry.

19 A The final page before the end, yes.

20 Q The final page of the letter, I should have said, rather than the final page of the tab.

21 A Yes, okay.

22 Q You can see on that page:

23 "Ofcom's model makes an adjustment to exclude depreciation costs in 2009-10,
24 relating to Excess Construction Charges. However, the costs in the regulatory
25 financial statements are already adjusted to exclude the depreciation relating to ECCs,
26 via a credit of £3.3m. BT therefore proposes that Ofcom's price reduction should be
27 reduced to this extent".

28 There may be a debate as to how that error originally came about, or whether BT should
29 have proffered, or indeed Ofcom should have asked for, a further explanation. But it seems
30 as though no-one has actually disputed that in fact that statement there is right.

31 A Are you asking if I am disputing whether it's factually right? I'm not disputing that; I don't
32 have any information.

33 Q What I am really suggesting is, are you saying that in those circumstances there is any real
34 incentive effects involved in this?

1 A What I'm saying is that they may have identified other issues. I'm not saying they have in
2 this particular instance of course. My overall comment is that I'm not commenting on these
3 three particular instances because I don't have enough information to do so. I'm merely
4 making a general point, which is that BT's informational ... would lead it to have an
5 incentive and an ability to identify potential changes to either the RFS voluntarily or to what
6 Ofcom is proposing in response that would be essentially cherry picked or selective. So I
7 don't have any particular comment on the statement that you've just read out or identified.

8 Q Sir, I am conscious of the time. I will stop there, Mr. Holt. Thank you.

9 THE PRESIDENT: Ms Rose, re-examination.

10 Re-examined by Ms ROSE

11 Q Mr. Holt, you were asked a question by Ms Lee about the extent to which a rental price that
12 was above DSAC could distort a decision from a CP as to whether to continue to rent a
13 particular circuit or take another option. You discussed with her a scenario where the
14 excess over DSAC was quite a modest amount.

15 A Right, yes.

16 Q Could you just take up core bundle B, the Determination, p.336 table 14.3 "Average
17 external revenue as percentage of external DSAC"?

18 A Yes.

19 Q What you see here is, for the relevant charges and the years in question, the actual
20 percentage by which DSAC was exceeded. If we take, for example, the BES 1000 rental,
21 you see the revenues were 485% of DSAC, then 687, 425%, 246%. Do you have any
22 comment about whether an excess of DSAC to that extent could distort the decision making
23 process of a communications provider?

24 A All I would comment is that those ratios of revenues to DSAC look very high.

25 Q What is the implication of that?

26 A The greater the extent to which the price is above DSAC, the greater the likely distortions
27 that would arise.

28 Q You were asked a question, but I am not sure that you were ever actually given the
29 opportunity to answer it, which was a situation in which the actual rental charge falls but
30 remains above DSAC. In that situation could there be a distortion in the decision making
31 processes?

32 A Yes, I think we sort of managed to describe this. My point was that the issue was less about
33 the pattern of rentals over time and more about the relationship between the level and the
34 pricing. So even if the rental charge is falling, there can still be scope for the various

1 distortions identified to the effect that the charge is still above the ceiling.

2 Q It was also suggested to you that you could not identify a true DSAC for the rental charge
3 because of the uncertainty in cost allocation. Do you have any comment to make about
4 that?

5 A I'm aware that there are DSACs, and there have been I think going back throughout this
6 whole period back to 2006/7. I'm also aware that, as we've just gone through in great
7 length, BT has a fairly extensive set of regulatory accounting documents and processes,
8 team and so forth, and that would suggest that it has taken great care, as great a care as is
9 possible, to produce those DSACs. So at any point in time it seems that they accept that
10 they've got the best information to produce those DSACs. More generally, I think the
11 comment applies that while BT is obviously a multi-product company (many firms are),
12 cost allocation is one of the ways in which you try to figure some of those charges out. It is
13 not particularly unusual to have to try to do cost attribution across different charges.

14 Q Thank you very much.

15 THE PRESIDENT: Thank you very much, Mr. Holt. We have no questions. You are released as
16 a witness.

17 Witness withdrew

18 THE PRESIDENT: As regards tomorrow, we are starting at 10 with Dr. Houpis. Mr. Thompson,
19 I think you are concluding your cross-examination in the morning, moving to questions of
20 interest. Considering the time spent today and the overrun, I think half an hour should be
21 sufficient to deal with that.

22 MR. THOMPSON: It is a large issue, in one sense.

23 THE PRESIDENT: It is an important issue financially, but the actual points arising on the
24 interest are quite confined, are they not? I think we are going to limit you to 30 minutes.

25 MR. READ: Sir, can I just interrupt my own leader and simply say that as far as I can see
26 (because I have actually discussed it with the parties) I am going to be quite quick with Mr.
27 Robinson. I shall not be more than about 30 minutes, probably less than that. I understand
28 that Ms Rose is not going to cross-examine Mr. Coulson. Mr. Saini and Mr. Pickford are
29 going to cross-examine. Their estimates are about one and a half hours/possibly two hours.
30 So actually, sir, although we have not run very well to timetable to date, I think we may be
31 in a position tomorrow.

32 THE PRESIDENT: Can you clarify about Mr. Robinson. Let me just remind myself. You are
33 the only person cross-examining?

34 MR. READ: I am the only person cross-examining.

1 THE PRESIDENT: You think you will only be about 30 minutes?
2 MR. READ: I will be no more than 30 minutes; I may be less.
3 THE PRESIDENT: Right, that is a considerable help. In that case, we will not impose quite the
4 same guillotine on you, Mr. Thompson. Forgive me just a moment. (Pause)
5 MR. THOMPSON: Can I take it as an indication, sir? I think I am only cautious because
6 experience suggests maybe five minutes, maybe ten minutes, and so a guillotine of 30
7 minutes does not entirely depend on my questions.
8 THE PRESIDENT: I understand that. We had thought that Mr. Robinson might be taking a bit
9 longer, but that certainly assists matters. We would like to be sure that Mr. Coulson starts
10 his evidence soon after midday, and there may be re-examination of Dr. Houpis. We have
11 some questions for Dr. Houpis. So that means that you having more than three quarters of
12 an hour with him could cause problems.
13 MR. THOMPSON: I will do my best.
14 THE PRESIDENT: If you work on that basis. The indication from Mr. Read is very helpful.
15 That means that we should be all right then tomorrow.
16 MR. THOMPSON: I obviously have more experience now of how it is likely to go, so I will bear
17 that in mind, sir.
18 THE PRESIDENT: Very well, 10 o'clock tomorrow morning. Can I just ask if by the end of
19 tomorrow those who have not responded on the confidentiality of that table which I asked
20 about at the outset (I think we heard from BT) --
21 MS ROSE: I am sorry, sir, it had slipped my mind. We are also content for those tables to be
22 non-confidential.
23 THE PRESIDENT: That is helpful, thank you.

24 Adjourned until 10.00 a.m. on Friday 8th November 2013
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